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"Foreign Aid as a Catalyst to Improving Domestic Revenue Mobilisation"

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EXECUTIVE SUMMARY

The deadline for meeting the Millennium Development Goals is looming. Meeting these goals requires financing for public expenditure programs. Foreign aid will remain critical for supporting these programs, and foreign aid commitments must be honored. However, there is also much scope for tapping into domestic resources to support development. Domestic revenues already significantly exceed foreign aid in most developing countries, including the very poorest. Interest in promoting domestic revenue mobilization has intensified in recent years, particularly after the global economic crisis. This study reviews the challenges faced in mobilizing domestic revenues and identifies numerous insights and recommendations on how the domestic revenue mobilization (DRM) systems in developing countries can be strengthened, both through actions on the part of program countries and through actions of the donors that assist them.

Revenue levels in program countries are affected by structural characteristics of the economy, tax policies and the legal system, and administrative capacities of revenue collection agencies. Reform of tax systems requires taking measures to increase the size of the tax base, including reducing the extent of preferential tax policies such as exemptions and tax holidays, introducing simplified payment schemes to bring the informal sector into the tax net, more effectively taxing high-income elites, energy firms, and other large taxpayers, and addressing cross-border tax evasion, which can deprive developing countries of significant revenues. Critical capacity constraints faced by collection agencies must also be eased through improvements in human and IT capacities and data availability. Collection agencies must more effectively engage with the taxpaying public and civil society, institutionalize a culture of taxpayer service, strengthen public-private dialogue, and coordinate with other government agencies. Perhaps most importantly, in order to achieve reform, strong support from leading political figures and building consensus for reform through education and public dialogue is essential.

Such reforms could have major impacts on revenue levels. For example, tax exemptions in Tanzania are estimated to equal 6% of GDP and, if collected, would have provided 40% more resources for education or 72% more resources for health. The payoff to reforming tax policies, strengthening institutional capacities, and improving international cooperation and accountability can be dramatic. Successful tax system reform also yields major dividends in improving governance. One of the most promising ways to promote reform is to intensify stakeholder dialogue and advocacy that permits citizens and civil society groups to play a greater role in shaping policies and institutions.

Donors have provided assistance to DRM reform through programs to improve tax policies, strengthen administrative capacities, and promote public-private dialogue, but this has comprised a very small part of official development assistance. In a typical program country, multiple donors usually provide DRM assistance, and there are a range of options for organizing the delivery of aid by multiple donors, each of which has strengths and weaknesses and none of which is obviously a dominant approach. Donor assistance in some instances needs to be better coordinated. Donors have often relied on assessing DRM reform progress using the tax-to-GDP

ratio, but this should be augmented with a broader set of indicators that indicates how revenues are collected as well as their level. Donor support to revenue collection also goes well beyond assistance programs: reducing cross-border tax evasion will require better cooperation between national tax authorities and may be worthy of a global initiative.

Finally, improving revenue levels will require reform to how they spent. Attention only to the revenue side of a country's budget neglects the reasons why these funds are raised in the first place. Taxpayers in developing countries are often reluctant to pay taxes because of a belief that they do not benefit from the programs that their taxes finance. Demonstration that public expenditure programs to achieve development are effectively and efficiently managed and are achieving results will allay concerns among domestic tax payers and promote revenue collection. It will also help donors demonstrate that their assistance programs are achieving intended outcomes and are a worthy expenditure of their countries' tax revenues. Conversion of foreign aid and domestic revenues into effective expenditure programs that achieve development requires reforms to public financial management and procurement systems, integration of transparent planning mechanisms into the budget process, strengthening of internal oversight mechanisms through the use of program analysis and evaluation, cost-benefit and cost-effectiveness analysis, transparent and objective performance measures, and stronger external oversight mechanisms that increase the involvement of public and civil society into the budget formulation process.

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1. DOMESTIC REVENUE MOBILIZATION CHALLENGES: AN OVERVIEW

If the Millennium Development Goals (MDGs) are to be met, more financing for programs in areas such as health, education, agriculture, and infrastructure must be made available. Many sub-Saharan African countries mobilize domestic revenues at levels below 20% of GDP, which is considered necessary to achieve the MDGs by the United Nations, and may need to raise their tax-to-GDP ratios by roughly 4%.[1][2]

Development finance is obtained from a variety of sources, including domestic revenues, private investment, foreign assistance, and remittances. Domestic revenues already account for a very large share of available development finance. Table 1 below shows that for low- and middle-income countries as a group, total revenues and tax revenues at the central government level as a share of GDP rose from 2002 to 2009 and greatly exceeded official development assistance (ODA) over the entire period.[3] During 2004-2008, the ratios for developing sub-Saharan African countries exceeded the ratios for low- and middle-income countries as a whole, and sub-Saharan revenue ratios were much higher than ODA ratios.[4] Developing countries are thus already primarily dependent on their own resources to finance development, a fact increasingly noted and emphasized by the development community.[5]

Intensifying this transition to reliance on domestically-generated revenue to finance development will yield significant benefits to developing countries. Risks associated with aid dependency and current uncertainty over levels of future aid flows are intensifying, and a greater de-

[1] This study was prepared by Dr. Bryan Roberts, Senior Economist at Nathan Associates. Opinions expressed are those of the author and do not necessarily reflect the official views of the United Nations.

[2] See United Nations (2005) and United Nations Development Programme (2010), p.26. Several approaches have been taken to assessing financing needs required to meet all of the MDGs or individual MDGs: see United Nations (2010), pp.3-5. This report emphasizes that because of the complexities involved in estimating them, single global estimates of financing needs and gaps, and the share of domestic and international resources allocated to meet them, have not been adopted by the international community. Countries have assessed needs and gaps on an individual basis as part of their development and anti-poverty strategies.

[3] Table 1 also shows that non-tax revenues are significant in all country groups, especially in high-income countries (primarily due to a high rate of social contribution payments), but also in developing countries, including sub-Saharan Africa.

[4] The relatively high average central-government tax-to-GDP ratio for sub-Saharan African countries may be due to technical reasons such as differences in tax policies. It might also be due to data issues: in particular, measured GDP may be too low for some African countries. It is also important to note that table 1 shows that the difference between general public-sector revenues and central government revenues, which approximate the level of local government revenues, is significant for both high-income/developed countries and low-middle income/emerging-developing countries as a whole, but much smaller for sub-Saharan African countries. The low level of local government revenues in sub-Saharan Africa, and their potential role in domestic revenue mobilization and facilitating meeting the MDGs, has received relatively little discussion. The IMF has noted that the impact of fiscal decentralization on revenue performance has not been clearly established (see International Monetary Fund 2011, p.57.)

[5] In a recent report, Bill Gates notes that "By far the largest supply of financing for development will continue to come from developing countries themselves. Developing countries' domestic resources are already much great than the ODA they receive, and domestic income is also growing much faster than ODA….The first key priority is for poor countries to raise more revenue." (See "Innovation With Impact: Financing 21st Century Development," a report by Bill Gates to G20 leaders, November 2011, p.8.)

pendence on domestic revenues will mitigate these risks. There are important synergies between improving domestic revenue levels and improving the quality of a country's governance. Reforms to revenue collection that permit greater financing of effective development programs from domestic resources illustrate the benefits of raising taxes, promote participation in the tax system, and can spark a positive feedback cycle. Greater reliance on domestic revenues increases the autonomy of national governments and promotes nation-state building.

Domestic revenues need to be raised in an economically efficient manner that does not impose undue burdens on investment and economic growth. Revenue mobilization is affected by the structural economic, demographic, and political characteristics of a country, its revenue policies and legal framework, and the efficiency and effectiveness of its tax administration.[6]

Structural characteristics of an economy will be little affected by reform efforts targeted at revenue policies and administration but play a significant role in determining revenue performance. Sub-Saharan economies are characterized by large subsistence agricultural sectors that are difficult to tax due to a low level of participation in market activity, and large informal sectors whose market activities are difficult to tax. More open economies that engage in a higher level of international trade tend to have higher revenues, perhaps reflecting the ease of taxing international trade flows. Revenue performance is also positively related to a country's income level, which could be related to better administrative capacities or demand for government services. Larger populations are associated with lower revenue performance, as is faster population growth, whereas aging populations tend to be associated with higher revenue performance. Higher price inflation is correlated with lower revenue performance due to lags in tax collection and failure to index tax parameters to inflation. Natural resource wealth is strongly associated with lower tax revenues from non-natural-resource sources. Foreign aid might displace tax revenues, although the evidence is not clear.[7] Finally, underlying political structures and the quality of governance and political and legal institutions also significantly impact revenue performance.

Revenue performance is substantially influenced by tax policies and the legal framework. Tax policy issues should be evaluated with respect to specific types of indirect taxes, which are imposed on transactions, and direct taxes, which are imposed on legal entities (persons or corporations.) Indirect taxes and challenges associated with them include:

- The *value-added tax (VAT),* which is a tax on consumption goods and services that is levied on value added during the production process. The VAT is implemented in many countries, including in sub-Saharan Africa, and has proven to be a robust revenue source that typically accounts for about 25% of all revenues. International advice favors a broad base, single tax-

[6] The following review is drawn from recent studies that review in detail the revenue policy and administrative challenges faced by developing countries. See International Monetary Fund (2011) for a comprehensive review of tax policy and administration issues, and empirical evidence on domestic revenue mobilization. See also "Supporting the Development of More Effective Tax Systems," Report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank, 2011.

[7] See IMF (2011), p.16, box 3.

ation rate, and a fairly high threshold for exclusion from being subject to the VAT. Actual VAT policies often deviate from these recommendations in developing countries and provide exemptions or differential rates in order to meet social or political goals. This has led to relatively low VAT revenue productivity in developing countries.

- Excise taxes, which are levied on the sale or production of specific goods (tobacco, alcohol, fuels (e.g. gasoline), cars, and luxury goods.) Excise tax revenues have been trending down somewhat over the past three decades, and their importance as a revenue source is relatively low in sub-Saharan Africa. Excises often serve both revenue and wider social goals. They sometimes induce smuggling and illicit production, which has caused many countries to hesitate to increase excise rates. International authorities believe that there is scope in many instances to raise significantly more revenues through excise taxes without worsening inequality.8

- Customs taxes, which are levied on imports (and, less frequently, exports) of goods and services. Customs revenue was traditionally an important revenue source in developing countries but have declined in importance over the last thirty years. They continue to be very important in sub-Saharan Africa, where they account for about 25% of tax revenues. Trade liberalization reduces tariff rates and thus customs revenues and is expected to continue in coming years.

Direct taxes and challenges associated with them include:

- The personal income tax (PIT), which is levied on the income of individuals or households. PIT revenues in developing countries have generally not been rising over time and account for 1-3% of GDP in developing countries as opposed to 9-11% in developed countries. Almost all PIT revenue comes from wage withholding in the formal sector (large firms and the public sector), and a small fraction of the population pays PIT. Measures to increase the PIT base have been a major focus in recent years. PIT evasion and avoidance by high-income individuals in many developing countries is a major issue, and although the exact level of revenues lost is difficult to quantify, the amounts involved are undoubtedly quite significant. Low participation of elites in paying PIT often mean that revenue collections are regressive in spite of progressive tax policies. Bringing these taxpayers into compliance can be the single most important potential source of domestic revenue, and increasing their participation rate is a major challenge. Measures that could help include eliminating exemptions for personal income earned abroad, improving collection of real estate taxes, establishing a dedicated unit in the tax authority for high-income individuals, improving audit capabilities, imposing meaningful penalties for noncompliance, and implementing international collective action to control abuse through tax havens.9

[8] See IMF (2011), p.39.

[9] Most countries also have also implemented a "global" income tax that progressively taxes the sum of income from all sources. The results of introducing a global income tax approach have generally been disappointing, and the merits of this approach are being reconsidered. Some developed countries have introduced an approach that taxes labor income and capital income separately using different schedules, and this may be an approach that could be useful for developing countries. See IMF (2011), pp.32-33.

- The *corporate income tax (CIT),* which is more important as a revenue source to developing countries than developed countries. CIT revenues have trended upward over the past three decades and have held up even in the face of globalization pressures. However, CIT exemptions and other forms of preferential treatment have become fairly widespread and include measures such as tax holidays and special tax treatment in free trade zones. These measures are intended to act as incentives that attract investment. Although they may have some impact on attracting investment, they also create the possibility of revenue leakage and deterioration in the general governance environment.[10] The spread of CIT incentives through competition for investment can lead to a "race to the bottom," and regional and unilateral initiatives to control this would help to control erosion of the CIT tax base. CIT revenues can also be impacted by transfer pricing practices and corporate structure arrangements, and tax authorities in both developing and developed countries have struggled to address this.[11] State-owned enterprises have also posed compliance issues, particularly with respect to mining and energy companies but also in some other areas (e.g. energy generation and telecommunications.)

Other tax policy issues that are important for developing countries include:

- *Taxation of small businesses,* which is a sector that is often difficult to tax, requires substantial administrative resources, and has limited revenue potential. Effectively taxing small businesses, however, may bring benefits that go beyond raising revenue, including reducing the size of the informal sector, improving taxpayer morale and promoting compliance of other sectors of the economy (e.g. larger businesses), enhancing state building, and improving business capacities of small businesses themselves. Complex tax schemes are an important disincentive for small businesses to pay taxes because they significantly increase compliance costs, and simplified taxation regimes for them have been established in many countries. A common feature of such schemes is to establish thresholds below which a business is subject to a lump-sum tax.
- Real estate taxation, which is an important source of revenue for local governments in many developed countries. Sub-Saharan countries typically have very low levels of revenue collection by local authorities (see table 1 and footnote 3), and this inhibits their ability to provide services. Property taxation in developing countries is often marked by low rates, multiple exemptions, poor or inaccessible ownership records, and infrequent revision of property values.
- Foreign aid flows, which are usually exempted from taxation in developing countries. This exemption is an important issue in sub-Saharan African countries, where aid flows are often significant relative to the size of the economy.

[10] Evidence on CIT incentives to attract investment is mixed. Business surveys and statistical research suggest that they matter but are less important than other considerations such as infrastructure quality, rule of law, and labor practices (see IMF (2011), pp.35.) IMF research has found that tax concessions were very costly in the east Caribbean region (between 9-16% of GDP), yet FDI flows did not appear to be influenced by them (see Jingqing Chai and Rishi Goyal 2008.)

[11] The impact of these cross-border considerations on revenues is not clear, and developing and retaining administrative capacity to address them is also expensive. See IMF (2011), p. 36.

- Tax expenditures, which are created by policies that forego tax revenues in order to finance government expenditure programs that do not explicitly appear in the government budget. A classic example of a tax expenditure program is the mortgage interest deduction, which subsidizes homeowners by forgoing PIT tax revenue on income that is used to pay mortgage interest. Tax expenditures can be quite large, and the revenue impacts of these preferential tax arrangements should be explicitly and routinely quantified and analyzed.[12] Such analysis is now common in some developing countries.[13]

Finally, revenue collection authorities often face capacity constraints and challenges that have a substantial impact on their ability to enforce tax policies and collect revenue. Agencies often experience high rates of staff turnover and the inability to recruit and retain staff with specialized knowledge due to uncompetitive remuneration policies and/or poor management practices. Technical challenges include inadequate IT systems and opportunities for e-filing, lack of high-quality data to support collections and audits, and poor communications systems. Capacities to engage in tax policy analysis and revenue forecasting are often weak. The provision of services to taxpayers is also often deficient, including facilitating public knowledge of taxpayer rights and responsibilities and implementing effective dispute resolution mechanisms. Tax laws and regulations are sometimes not clearly written and made readily available to the public. Weak administrative capacities lower the volume of revenue collected, increase the degree of revenue leakage through inefficiency and corruption, and increase the collection cost per unit of revenue.

In addition to these technical and administrative challenges, reform of domestic revenue mobilization (DRM) also involves many important political economy issues, at both the domestic and international levels. Perhaps most importantly, reform depends on the political will of governing elites: without political will, meaningful reform and capacity development might not happen even with support and pressure from external parties. Second, although DRM aid typically concentrates on technical issues as opposed to political dialogue and advocacy, DRM reform can play a critical role in promoting good governance and increasing accountability of the state. Bargaining between governments and taxpayers has historically played an important role in state building and the emergence of democratic governance. Third, achieving voluntary compliance in tax payment depends on perceptions by taxpayers of what they receive for their compliance. Revenue mobilization is thus affected by the quality of expenditure planning and management, and the need to raise revenues should be justified to the public by showing transparently and objectively what is obtained for those revenues. Finally, there are important international political economy aspects to DRM reform. Tax evasion is facilitated by practices in other countries, and international coordination and support are required if erosion of the tax base due to cross-border evasion is to be reduced.

[12] Tax expenditures in the United States in 2010 are estimated to have cost the federal government $1 trillion and comprised 25% of government expenditures (see Hungerford 2011).
[13] See IMF (2011), p.43.

The potential to raise domestic revenues to support achieving key development goals in developing countries is clear. Tax evasion and avoidance may often exceed the value of official development assistance. Foreign assistance to developing countries has sometimes included a component dedicated to improving a country's ability to raise domestic revenues through strengthening and improving administrative capacities, tax policies, and the governance environment. This study begins with a review of the key characteristics of foreign assistance to strengthen DRM, including the different modalities through which assistance can be provided and managed. Insights and recommendations are then reviewed that are drawn from case studies of several sub-Saharan African countries, the broader literature on DRM reform, and stakeholder dialogue at a recent high-level United Nations forum. Key linkages and issues involved in the use of mobilized revenue to achieve development goals (the MDGs) are then evaluated. Two appendices provide detailed case studies of six sub-Saharan African countries that review in detail donor support of DRM reforms and their outcomes (appendix A) and a detailed review of DRM aid modalities (appendix B.)

Table 1
Revenues and Net ODA as a % of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Central-Government Revenues Only									
High Income Countries									
Revenues	25.9%	25.6%	25.5%	26.3%	26.8%	26.9%	26.1%	24.9%	
-of which: Tax revenues	15.1%	15.1%	15.3%	16.0%	15.8%	16.1%	15.2%	13.6%	
Non-tax revenues	10.8%	10.5%	10.2%	10.3%	11.0%	10.8%	11.0%	11.3%	
Low and Middle Income Countries									
Revenues	16.8%	17.1%	17.4%	18.4%	19.2%	21.4%	19.7%	18.6%	
-of which: Tax revenues	11.4%	11.8%	12.0%	12.8%	13.8%	14.0%	14.0%	13.0%	
Non-tax revenues	5.4%	5.2%	5.4%	5.5%	5.4%	7.4%	5.7%	5.7%	
Net ODA received	1.0%	1.0%	1.0%	1.1%	0.9%	0.8%	0.7%	0.8%	0.7%
Of which: Sub-Saharan Africa									
Revenues			22.3%	23.3%	24.2%	24.5%	24.3%		
-of which: Tax revenues			17.4%	17.5%	17.7%	17.8%			
Non-tax revenues			4.9%	5.8%	6.5%	6.8%			
Net ODA received	5.5%	5.6%	4.8%	5.1%	5.5%	4.1%	4.1%	4.7%	4.1%
General Government Revenues									
Revenues for:									
Advanced economies	35.5%	35.7%	35.8%	36.8%	37.6%	37.9%	37.5%	36.1%	36.0%
Emerging/developing economies	24.1%	24.8%	25.8%	27.8%	28.7%	28.8%	29.6%	26.5%	27.0%
-Sub-Saharan Africa	24.3%	24.6%	25.9%	27.6%	30.0%	27.8%	29.6%	24.2%	26.2%

Sources:
Central government revenues: World Development Indicators database. Revenues and non-tax revenues exclude grants. Non-tax revenues include most social contributions, rent, fees, fines, and income from property or sales.
General government revenues: IMF World Economic Outlook database.

2. FOREIGN AID SUPPORT TO DOMESTIC REVENUE MOBILIZATION: SIZE, STAKE-HOLDERS, AND MODALITIES

2.1. Size of Foreign Assistance for Strengthening Domestic Revenue Mobilization

Donor support to strengthen DRM system capacities is one component of support provided to strengthen public sector capacities generally.[14] The latter averaged roughly 4.5% of total ODA aid flows for all developing countries and for sub-Saharan African countries specifically during 2002-2009 (see table 2 below). However, aid specifically allocated to support DRM capacities is only one component of these amounts. It is not entirely clear how much of the flow is specifically related to DRM-related reforms, but available evidence suggests the proportion is quite small. The OECD has stated that total aid for "tax- and revenue-related tasks" comprised $185.6 million in 2007, which is 0.16% of all ODA and 2.7% of aid supporting strengthening of public sector capacities.[15] Assistance for DRM is thus a very small component of overall aid, and even aid specifically directed to supporting strengthening of public sector capacities.

Table 2

(million US$)	2002	2003	2004	2005	2006	2007	2008	2009
All Recipients								
Total ODA	54,808	68,324	78,623	112,572	150,282	112,976	129,411	133,708
ODA for PFM, policy, and admin.	2,400	2,396	4,174	6,608	5,431	6,827	6,241	5,460
-% of total ODA	4.4%	3.5%	5.3%	5.9%	3.6%	6.0%	4.8%	4.1%
Sub-Saharan African Recipients								
Total ODA	17,710	24,238	27,185	34,918	77,718	36,195	40,393	44,145
ODA for PFM, policy, and admin.	888	938	1,361	1,479	1,608	2,115	2,006	1,578
-% of total ODA	5.0%	3.9%	5.0%	4.2%	2.1%	5.8%	5.0%	3.6%

Disbursed aid flows from all donors and including all types of aid as recorded in the OECD aid statistics database. DRM-related aid includes aid for public finance management (sector code 15111) and aid for public sector policy and administration management (sector code 15110).
Source: OECD aid statistics database: http://stats.oecd.org/qwids

2.2. Aid Stakeholders

Although the magnitude of DRM assistance flows is relatively small, the number of potential stakeholders in DRM assistance is large. DRM assistance is provided by several donor organizations. International organizations such as the IMF and the World Bank often play an important role in DRM assistance, with the IMF often providing technical assistance through short-term resident advisors consulting on specific DRM issues and visiting missions from the IMF's Fiscal Affairs Department, and the World Bank supporting longer-run DRM programs to build and de-

[14] This support includes assistance to strengthen capacities in the areas of public finance management (PFM), public sector policy, and administration management. Assistance to strengthen DRM capacities is a subcomponent of support to PFM.

[15] See OECD (2008a), p.3. The OECD has also stated that "Of the USD 7.1 billion spent in 2005 on bilateral aid for government administration, economic policy and public sector financial management, only 1.7% went on tax related assistance" (see OECD 2008b, p.27.)

velop revenue authority capacities. Bilateral development agencies of countries such as the United States (USAID), Germany (GIZ and KfW), the United Kingdom (DFID), Canada (CIDA), Denmark (DANIDA), Norway (NORAD), Sweden (SIDA), and Switzerland (SECO) have provided considerable DRM assistance to various recipient countries. Regional development banks such as the African Development Bank (AfDB) and the Asian Development Bank (ADB) have also provided assistance to DRM reforms. Programme-country stakeholders are also numerous. Public-sector stakeholders include the revenue collection authority, the Ministry of Finance, Parliament, social security and/or pension-related ministries and authorities, and regional- and local-level government authorities. Important stakeholders from civil society include taxpayer associations, business associations, and organizations advocating against corruption.

2.3. Aid Modalities

Much donor assistance in the past has been provided through bilateral projects in which a donor organization manages its assistance and relationships with recipient stakeholders independently from other donors. Over the past two decades, new aid modalities have emerged that seek to increase aid effectiveness through better alignment, harmonization, and mutual accountability in a context of multiple donors and stakeholders. The modalities available to the donor community include:

- *General budget support (GBS),* which transfers resources from a donor to a partner government's national treasury that are then managed in accordance with the recipient's budget procedures;
- *Sector budget support (SBS),* which is a transfer of resources to a national treasury in support of a sector program, policy and strategy. It does not differ procedurally from GBS but supports a sector strategy as opposed to a national development strategy;
- *Basket financing,* which entails pooled multi-donor funding that goes not to a national treasury but to a segregated account or sub-account for designated purposes;
- *Other joint instruments* that provide funding outside the host government's budget. Joint-instrument options include *trust funds* and *joint projects or programs* and have been used for many years to pool resources from multiple aid agencies to support a common program;
- *Bilateral arrangements*, which consist of "stand-alone" arrangements between a host government and individual donors and continue to account for a large share of aid flow to developing countries.

The donor community and program countries thus have a range of modality options through which to implement DRM assistance. Appendix B describes in more detail the basic feature of these modalities and reviews key issues associated with them as a mechanism for delivering assistance. An important lesson of experiences to date is that no particular modality obviously dominates the others in terms of meeting best-practice criteria for aid delivery. Each has its own strengths and weaknesses, and there has been considerable learning about how to improve and strengthen particular modalities in recent years.

3. DOMESTIC REVENUE MOBILIZATION REFORM, PROGRAMMATIC SUPPORT FROM EXTERNAL PARTNERS, AND ACHIEVING DEVELOPMENT GOALS (THE MDGS): KEY INSIGHTS AND RECOMMENDATIONS FROM CASE STUDIES AND STAKEHOLDER DIALOGUE

Deeper insights into the effectiveness, impact, and sustainability of aid in increasing domestic revenues can be gained by examining case studies of specific country experiences. This section summarizes key insights from the experiences of sub-Saharan African countries. Detailed case studies of Ghana, Liberia, Mali, Mozambique, Tanzania, and Uganda are presented in appendix A. Each case study provides a high-level overview of economic and revenue challenges facing the country in recent years, and a review of the management and impacts of foreign aid provided to the country for general purposes and to support revenue mobilization reform. In addition to these case studies, insights and recommendations are also drawn from case studies on several sub-Saharan African countries prepared for a 2010 workshop sponsored by the African Development Bank Group on domestic resource mobilization for poverty reduction in East Africa.[16] This section is also informed by the broader literature on revenue reform in developing countries, and insights and recommendations resulting from stakeholder dialogue at the October 2011 High Level Symposium held in Luxembourg in preparation for the 2012 DCF.[17]

3.1. Key Insights and Recommendations Related to Program-Country Policies and Capacities

- *Political economy factors play a central role in shaping the DRM system and its outcomes.* The political economy affects tax policies, revenue outcomes, the impact of DRM reform efforts, the success of DRM in enabling achieving the MDGs, and all other important aspects of the DRM system and the outcomes it produces. How the political system operates, its institutional organization, the objectives, incentives, and constraints of its key players, and other aspects of the political economy will play a central role in DRM and MDG outcomes. Specific aspects of this nexus are discussed in more detail below. The importance of political economy factors means that a focus only on technical issues will often be inadequate to achieve meaningful progress in DRM reform and achieving the MDGs.

- *Synergies between revenue reforms and governance.* DRM reforms can yield major improvements in governance in program countries. Professionalizing the revenue authority may motivate similar reforms in other ministries. Measures that increase the level of voluntary taxpayer `compliance directly improve a country's governance quality and may result in spillover pressure on other areas of public-private sector contact. DRM as-

[16] The countries include Burundi, Kenya, Rwanda, South Africa, Tanzania, and Uganda. Relevant documents, including a summary of lessons for tax policy and administration, are available at http://www.afdb.org/en/news-and-events/article/workshop-on-domestic-resource-mobilization-for-poverty-reduction-in-east-africa-7317

[17] Key references for this section include Nathan Associates (2011), International Monetary Fund (2011), and IMF, OECD, UN and World Bank (2011). Stakeholder dialogue at the Luxembourg meeting, on the panel entitled "Aid to Catalyze Domestic and External Resources: What Have We Learned?" provided additional insight.

sistance should give special weight to activities that address these synergies. Good governance also requires consultation, education, and training for all stakeholders about changes in policies and systems and their procedures, an area in which DRM assistance can play a very useful role. It is also important to recognize that linkages between revenue collection and governance involve supporting institutions and organizations outside of the revenue system, including the justice system, Parliament, and civil society.

- *Host-country political leadership and ownership:* Strong support from leading recipient-country political figures is of paramount importance if rapid and significant progress is to be made in strengthening revenue collection capabilities and policies and increasing domestic revenues. Aid can effectively support government programs to improve the revenue system, but it generally cannot "buy" effective and lasting reforms that are not aligned to political incentives. Strong leadership commitment in Liberia helped achieve rapid revenue increases in a highly challenged post-conflict environment. Leaderships in several other countries seem to have made strengthening revenue collection a significant priority, although reforms continue to be needed in critical areas, particularly with respect to "the culture of exemptions" (see below.) Effective leadership is also critically important in fostering effective communication between different divisions of revenue authorities, and between revenue authorities, Ministries of Finance, and other relevant government agencies, so as to avoid a "silo mentality" in implementing DRM reforms.

- *Linkages between national development strategies and tax policies.* Tax policy choices should be shaped by a country's development strategy. For example, a development strategy based on a policy of economic liberalization and integration with global markets will dictate tax policies that may not always be appropriate for a development strategy that places a relatively stronger emphasis on public good provision. Best practice requires that tax policies be adopted on the basis of careful analysis of costs and benefits associated with them, and this analysis should be conducted taking into account priorities identified in development strategies.

- *Tax system progressivity and achieving the MDGs.* Although authorities may generally intend to have a progressive tax system, actual tax policies and administrative practices can result in regressive outcomes. Many countries face challenges in collecting taxes from individuals and organizations possessing strong influence in the political system.[18] This poses an issue for achieving the MDGs to the degree that achieving these goals requires progressivity in the tax system.

- *Widening the tax base.* Measures to widen the tax base by bringing the informal sector into the tax net are desirable and can be achieved through appropriate policy change

[18] In terms of income tax, outcomes in many developing countries (and some developed countries, e.g. the United States) may better fit a "progressive-regressive" profile, in that a large number of poor households are formally excluded from paying tax by official policies or simply evade tax payment, a middle-income segment incorporated into the formal sector pays taxes at the highest rate and accounts for the bulk of income tax revenue, and an elite segment pays taxes at a lower rate or simply avoids most payment.

(eg introducing a simplified tax regime for micro and small enterprises.) Success of these efforts will also depend on broader reforms that influence popular attitudes about the quality of governance. If the tax base is successfully widened, and if new tax payers see results in terms of successful expenditure programs that help achieve development goals such as the MDGs (see section IV below), the legitimacy of the tax system will be significantly enhanced, and a positive-feedback cycle between increased levels of voluntary compliance and effective use of tax revenues could be initiated. The experience of Mozambique suggests that such a cycle happened there over the past decade (see appendix A).[19]

- *Preferential tax policies:* The proliferation of exemptions and special treatment for specific products, companies, and sectors in tax policies is cited as a major challenge for DRM reform in almost every country for which a case study is available.[20] Such exemptions can be found in both indirect (eg VAT, excise duties) and direct (eg income, corporate profit) taxes. Tanzania provides a striking example of the importance of exemptions: it is estimated that exemptions currently account for up to 6% of GDP and, if they had been collected in 2009, would have provided 40% more resources for education or 72% more resources for health (see case study in appendix A.) Preferential tax policies are a key way in which tax avoidance is facilitated. These policies are often implemented to attract foreign direct investment or promote exports. In Tanzania, for example, the bulk of exemptions are provided to firms in special export and investment zones and in the mining sector, and multinational firms benefit from them to a significant extent.[21]

- *Local government revenues.* There is a very low level of revenue collection by local governments in sub-Saharan African countries, whose finance is usually provided by the central government. Developing local government collection capacities could be an important area for DRM assistance. Fiscal decentralization and local tax mobilization is also relevant to provision of public goods and achieving development goals. In sub-Saharan Africa, local governments in some countries are assigned a relatively restricted set of expenditure responsibilities, whereas in other countries, they are required to finance education, health, and other social services. For these countries, dependency on discretionary transfers from central governments could negatively impact meeting expendi-

[19] Governments and donors should, however, have realistic expectations about the *immediate* revenue impacts of tax base widening: the experience of Mozambique suggests that such measures will often not immediately result in a significant increase in revenue collection, even though in the longer run a positive-feedback cycle may have emerged there.

[20] For example, every country study prepared for the workshop on domestic resource mobilization for poverty reduction in East Africa cited exemptions in excise, VAT, and/or income taxation as an important problem for fairness and efficiency of tax policies. Preferential tax policies are a problem not only for developing countries: the United States, for example, has many "tax expenditure" policies whose value amounted to roughly $1 trillion in 2010 (see Hungerford 2011.) Quantitative study of the total value of tax exemptions and their economic impacts in sub-Saharan African countries would be very valuable for better understanding what preferential policies cost these countries in terms of revenue and economic efficiency.

[21] Evidence is mixed on the degree to which such incentives achieve their goals: see section I, footnote 9. The costs and benefits associated with preferential tax policies should always be carefully evaluated.

ture responsibilities and development goals. Linkages between local taxation and public service provision need to be made explicit and better understood and analyzed, as well as the potential for local revenue mobilization to support achieving the MDGs.

- *Non-tax revenues and management of energy-sector revenues.* Non-tax revenues are a significant component of overall revenues and should not be neglected by DRM assistance. A particularly important non-tax area is energy-sector revenues, which should be managed under a transparent and rule-based framework. Most of the case-study countries have adopted or are adopting such frameworks.

- *Large taxpayer units.* Large taxpayer units are a very important component of revenue authorities. If established and properly run, these units are capable of collecting a majority of tax revenues in sub-Saharan countries (as illustrated by the experience of Ghana.) It is not entirely clear how DRM assistance can best assist authorities in this area, which is sensitive as these units are inherently responsible for taxing a country's elites.[22]

- *Institutional organization of domestic revenue institutions:* Organizations responsible for revenue collection and policy making functions need to be coordinated well or institutionally integrated. Most case-study countries began their reform efforts in the 1990s by establishing a unified revenue authority. Excessive autonomy of individual revenue collection offices (income tax, VAT, customs, etc) can result in poor collection performance and revenue policy implementation. The quality of interaction between the revenue collection authority and the Ministry of Finance is also very important, as tax policies are usually set by the Ministry of Finance, which also sometimes implements or oversees tax appeals or ombudsman processes. Donors can provide advice and support for better organization and coordination of these functions but should avoid interfering with ownership.

- *Organizational reforms of revenue collection authorities.* These reforms continue to be needed and should be made a priority. Reforms that reduce the opportunity for tax payment to be carried out in discretionary ways and lower the possibility of corruption and resulting reduced revenues are particularly desirable.[23] Computerization can help in this regard but is not sufficient. Revenue authorities must also have in place internal oversight mechanisms and internal audit functions that are effectively implemented.

- *Developing a culture of customer service in tax collection agencies.* Collection agencies in many developing countries have often not taken actions to promote a culture of customer service that facilitates and encourages tax payment. Such actions include, for example, outreach and informational campaigns to improve tax payer knowledge, codifi-

[22] See IMF (2002) for a review of the issues involved with improving compliance of large taxpayers.

[23] A traditional practice in corrupt tax administrations is for tax collectors and tax payers to hold meetings in which the amount of taxes collected is subject to face-to-face negotiation. Tax collectors permit reporting of a much lower level of a tax base than is actually the case and receive a bribe payment in return. The sum of tax paid and the bribe is in turn lower than the true amount of tax that the tax payer owes to the government, so that both parties experience monetary gain.

cation of taxpayer rights and obligations in law and adoption of a taxpayer rights charter, and adoption of internal incentives to improve the quality and speed of processing of returns. Improved customer service encourages voluntary compliance and widening of the tax base.

- *Information technology.* Computerization of business processes related to tax payment continues to be a significant need in case-study countries. This includes computerization of internal processes in the revenue authority, and introduction of e-filing to enable taxpayers to more efficiently meet requirements. DRM assistance has often played a major role in this area. However, experience with introducing IT systems for tax administration suggests the need for careful planning and costing, realistic project scoping, and intensive coordination among donors providing support in this area.

- *Introduction of e-taxation.* Enabling tax payers to file electronically should yield major improvements in the ability to pay taxes and the cost of doing so in terms of time and effort and can play a role in widening of the tax base. It will also help reduce opportunities for corruption. An effective e-filing system requires appropriate human resource capacities and related training.

- *Revenue authority human capacities.* Personnel and managerial issues are often a major challenge for revenue authorities in developing countries. Recruiting, retaining and effectively managing qualified personnel and supervisory staff is difficult. Revenue authorities must compete with the private sector for human talent but often cannot offer competitive salaries. DRM reform should seek to support facilitating organizational change that address these issues whenever possible.

- *Data adequacy.* Information availability and quality are often problematic for revenue authorities, including data that they should collect and process themselves, but also data that should be provided by other state agencies and organizations (eg company and property registries, household surveys.) Data acquisition and processing involves expense and requires appropriate expertise. Donors sometimes help finance data acquisition efforts in program countries, including in sub-Saharan Africa.[24]

- *Research capabilities.* Revenue collection authorities and Ministries of Finance often have limited ability to conduct research that can ensure optimal tax policy design, support risk-based allocation of enforcement efforts, inform strategic planning, and project economic trends and revenue collection. Donor-supported technical assistance can play a very useful role in strengthening these capabilities.

[24] Data issues in sub-Saharan African countries can be particularly acute. For example, national income estimates are often based on surveys of households and/or businesses that are many years old. When new surveys are carried out, the level of per-capita income can be revised upwards by as much as 50%, or even more. This creates obvious difficulties for assessing a country's revenue performance.

- *Improved communication and coordination between developing countries.* Regional collaboration between Southern actors has been intensifying, as evidenced by developments such as the recently established African Tax Administrators Forum (ATAF) and the growing number of double taxation agreements between developing countries. There is widespread consensus on the growing importance of regional organizations for promoting DRM reform and enhancing governance.[25] Knowledge sharing and horizontal partnerships among Southern actors have also been instrumental in tackling global tax challenges that go beyond national borders. Regional collaboration in areas such as taxation of multinational companies should be promoted. Regional initiatives to reduce illicit capital flight should also be further strengthened.

3.2. Key Insights and Recommendations Related to Donors and Their Support to DRM Reform

- *Integration of demand-driven assistance into national strategy frameworks. DRM assistance should be provided as one component of an overarching development strategy and should support revenue collections whose levels and structure are derived from national strategies for poverty reduction and economic growth. Many case-study countries have apparently achieved implementation of such frameworks. Donor assistance should also be demand driven by the needs of national authorities, civil society organizations, and the development strategy.*

- *Modalities to deliver DRM reform assistance. There are many options availability for delivering DRM assistance, including GBS, SBS, basket financing, bilateral assistance, and other mechanisms (see appendix B for details.) For achieving DRM reform, no obvious "best" modality is suggested by the case studies of country experiences: all modalities are capable of contributing productively to DRM reform efforts. However, it is also clear that there are several ways in which the effectiveness of a particular adopted modality could be improved.*

- *Coordination of donor assistance. An important best practice for DRM assistance is that support from multiple donors needs to be well coordinated under the leadership of relevant national authorities.26 Country experiences also suggest that donor coordination can be ensured through appointing a lead donor to coordinate with the government. The need to improve donor coordination generally is an important goal of the Paris declaration, and there has been some progress in improving donor coordination and reducing aid fragmentation.27 In the case of DRM reform, the case studies presented in appendix A reveal examples of ef-*

[25] See Nathan Associates (2011), pp.30-41, for a review of South-South regional organizations related to DRM.
[26] The Ministry of Finance should often take the lead role, but the tax collection authority and other relevant line agencies should be involved, and involvement of the office of the Prime Minister or President may also be necessary to ensure success.
[27] See OECD (2011). The only Paris Declaration indicator that was met in 2010 was the "percentage of technical co-operation implemented through coordinated programmes consistent with national development strategies" (OECD 2011, p.19) However, targets for joint missions and joint country analytic work were missed.

fective donor coordination, and some instances of poor donor coordination that has negatively impacted support effectiveness.

- *Assistance to stakeholder dialogue and advocacy and civil society organizations. Given the importance of political economy factors, which can play the decisive role in determining the degree of success of DRM reform, donor assistance should make promoting stakeholder dialogue and advocacy a major focus as well as support to improving capacities of the revenue collection authorities. Strengthening of civil society dialogue is critically important for improving the perceived legitimacy of the tax system in many countries. Although DRM assistance has traditionally focused on technical areas, stakeholder dialogue and advocacy and civil society capacities are beginning to receive more attention.*

- *Assistance from developed countries to assist in revenue collection goes beyond assistance to DRM reforms. Cross-border tax evasion is significant, and developed countries have played an important role in facilitating it. Oxfam estimated that in the 1990s, developing countries did not collect domestic revenues of $50 billion annually from trans-national companies due to tax avoidance and evasion, which roughly equaled the average value of annual foreign aid flows to developing countries. According to Oxfam, "there is no doubt the implied human development costs of tax havens are large. The US$50 billion loss is equivalent to six times the estimated annual costs of achieving universal primary education, and almost three times the cost of universal primary health coverage."28 Better cooperation between national tax authorities on these issues needs to be encouraged through cross-border collaboration, global initiatives to reduce cross-border tax evasion, and similar such measures.29*

- *Application of conditionality. Donors often loosely apply revenue conditionality in assistance agreements when revenue performance fails to meet targets. This was true in several case-study countries (with Tanzania being the one exception.) This raises the broader issue of when donors should exit support of DRM reforms.30*

- *Indicators for measuring progress in DRM reform. Donors have often focused on using the tax-to-GDP ratio to measure improvement in DRM system performance and the effectiveness of assistance. However, tax authorities have limited or no influence on some of the key*

[28] Oxfam regarded $50 billion as a conservative lower bound to the true value of uncollected revenues. See Oxfam (2000).

[29] The Tax Justice Network is an initiative to conduct research and advocacy on international tax evasion, avoidance, and havens (http://www.taxjustice.net/cms/front_content.php?idcatart=2&lang=1). The Stolen Asset Recovery Initiative is administered by the World Bank and the United Nations Office on Drugs and Crime and works with developing countries and financial centers to prevent the laundering of the proceeds of corruption and to facilitate more systematic and timely return of stolen assets. The possibility of establishing an initiative on cross-border tax evasion analogous to the Extractive Industries Transparency Initiative (EITI) could be explored. EITI is a multinational initiative that promotes transparency in payments related to extractive industries through a range of activities, including a statement of principles, six criteria, reporting guidelines, administration of a trust fund, an annual conference, and promoting dialogue of key stakeholders, including national governments, international organizations, corporations, and NGOs.

[30] See Nathan Associates (2011), pp.56-57, for a review of exit issues related to DRM reform assistance.

drivers of this ratio, such as the level of overall economic activity and tax policies adopted by the government. It is also very important to measure how taxes are collected, and how the tax system affects development performance. A wide range of indicators are available that can be used to assess progress in results more tightly under the control of tax authorities.31 These indicators have in many instances been used to monitor progress in the context of a multi-donor supported DRM reform effort.

- *DRM reform and overall aid flows. Program countries are generally very supportive of using aid as a catalyst to increase domestic revenue levels. There is concern, however, that improved DRM performance may come at the expense of reduced development assistance in the longer run. A key responsibility of the donor community is to sustain overall assistance to meet the MDGs even as improved domestic revenue performance is experienced.*

- *Development cooperation dialogue. DRM reform should be brought into the development cooperation dialogue. At regional and global levels, existing initiatives (for example, the ATAF) produce valuable policy recommendations for country-level programming. These initiatives should be built upon to develop a focus on DRM in development cooperation. They should become an integral part of discussions on effective development cooperation. It should also be ensured that such initiatives do not duplicate efforts.*

- *Non-DAC donors. There is no evidence that non-DAC donors are playing a significant role in DRM assistance specifically. In terms of broader aid flows, the experience of Liberia suggests that challenges are faced with achieving proper tracking, monitoring, and coordination of this funding.*

- Achieving higher levels of domestic revenue collection is desirable because these revenues are used to finance achieving key development goals, most notably the MDGs. Several insights and recommendations presented above touch on some issues related to the ability of DRM reform to support achieving the MDGs. The following section reviews in more depth what is required to convert revenues into expenditure programs that most effectively achieve the MDGs. If revenues are mobilized but poorly allocated and ineffectively spent, then they will do little to promote development.

[31] See Nathan Associates (2011), pp.51-54, for a thorough review of revenue-related indicators, which can be classified as measuring inputs, outputs, or outcomes of DRM reform activities. Many indicators can also be used to monitor synergies between taxation and governance. See also "Domestic Resources Mobilization for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration," pp.4-5 for discussion of indicators related to tax administration efficiency, revenue productivity, and operational capacity of tax authorities in East African countries.

4. DOMESTIC REVENUE MOBILIZATION AND ACHIEVEMENT OF KEY DEVELOPMENT GOALS : LINKAGES AND ISSUES

Whatever their source, any funds that are raised for development must be converted into effective and well-managed expenditure programs in order to impact development outcomes and achieve development goals. The key linkages involved in converting financial resources into development outcomes are illustrated in the figure below. Green boxes indicate a source of development financing, and the red box is the ultimate target of a set of key development outcomes, notably the Millennium Development Goals. *Foreign investment* is a private-sector flow that finances investment projects, and these promote overall economic activity and domestic revenue mobilization. *Remittances* are private income transfers from nationals working abroad to domestic households, and a portion of these transfers support health and education expenditures by recipient households and thus directly contribute to achieving development goals. Remittances are also sometimes organized into flows through hometown associations that help finance community projects such as construction of schools, churches, or municipal infrastructure. *Foreign assistance* is channeled into the government budget as general budget support (GBS) or sector-specific support, or into support for specific projects and programs in the public and non-public sectors. A medium-term expenditure framework (MTEF) plans *domestic revenues* and the public expenditure programs that they finance, and ideally also incorporates foreign assistance and other development finance flows so as to provide a comprehensive framework for financing and expenditure planning, monitoring and evaluation.[32]

Domestic revenues are mobilized to finance public expenditure programs, which include programs that directly impact economic and social outcomes related to development goals, and programs that do not. Examples of the former include public programs that finance health, education, agricultural development, and infrastructure, and transfer programs that reduce poverty through income support. An example of the latter is defense spending. Domestic revenues will support the achievement of development goals to the extent that they are channeled to programs that produce development-relevant outcomes, and to the extent that program expenditures are effective at achieving results. As with the need to raise more domestic revenues, the need for greater transparency and accountability in the use of those revenues is being increasingly emphasized in the development community.[33]

[32] There are many linkages and feedback loops that could be included in the diagram below that are excluded for the sake of simplicity. Foreign investors sometimes finance development projects directly as part of their business operations. Foreign assistance often includes projects and programs that seek to promote private-sector activity and economic growth. All sources of development finance also create jobs and income flows that stimulate overall economic activity and support domestic revenue mobilization. Remittances typically augment incomes of relatively poorer households and have been shown in many studies to lower poverty in communities that receive them. Linkages between policies (eg revenue policies) and overall economic activity have also been excluded.

[33] For example, a recent report by Bill Gates notes that "Ultimately, developing countries' domestic resources will be the largest source of funds for development. To maximize the impact of these resources, poor countries must raise more revenue; spend it on priorities like agriculture and health, which many have committed to do; and, following the lead of G20 countries that pioneered impact evaluation, measure the cost-effectiveness of their programs." (See "Innovation With Impact: Financing 21st Century Development," a report by Bill Gates to G20 leaders, November 2011, p.4.)

Governments plan revenues and expenditures annually in the state budget, but the annual budget necessarily concentrates on the immediate future and has limited use as a medium-run planning framework that takes into account the dynamics of program expenditures and their impacts. The medium-term expenditure framework (MTEF) has become popular as a tool for planning revenues, expenditures, and program outcomes and results over a horizon of three to five years. MTEFs integrate top-down resource constraints with bottom-up expenditure program planning. They are generally regarded as a vehicle through which development strategies such as Poverty Reduction Strategy Papers (PRSPs) can be translated into concrete public expenditure programs while also taking into account macroeconomic, fiscal, and sectoral prospects and constraints. An MTEF enables governments to plan expenditure programs according to development priorities and to enhance budgetary predictability and accountability for results.[34]

Any public expenditure program that is funded in part or in full by domestic revenues can be evaluated in terms of inputs, outputs, and outcomes. Inputs are the resources used by the program, outputs are immediate results generated by the program, and outcomes are program impacts of ultimate significance to public welfare and development goals. An important implicit feedback loop in the figure below is between development outcomes and public expenditure programs. Transparent and objective analysis of programmatic results should influence budget planning and expenditure prioritization such that a performance-based allocation of mobilized domestic resources is achieved. If analysis reveals that some programs are much more effective than others in achieving development results, resource allocation should be reprioritized as a result.[35]

A full review of the many issues involved with converting domestic revenues into effective public expenditure programs that achieve development goals is beyond the scope of this paper. Several key challenges that should be emphasized include:

- *Weak public financial management (PFM) and procurement systems.* Tools such as MTEFs and PSRPs that contribute to the prioritization and design of expenditure programs must be coupled with effective PFM and procurement systems that have strong internal controls and reporting and audit functions to achieve desired results. Recent evidence suggests that progress has been made since the early 2000s in the strengthening of PFM systems in developing countries (although considerable variation in PFM quality continues to exist.)[36]

[34] A review of the many issues associated with MTEFs and their implementation is beyond the scope of this paper. For an early reference on the implementation of MTEFs in African countries, which have extensively adopted them, see World Bank (2002).

[35] Performance-based delivery of foreign aid has been an important focus for the foreign aid community in recent years: see, for example, Koeberle et al (2006).

[36] See OECD (2011), chapter 3.

- *Lack of meaningful integration of transparent planning mechanisms into the budget process. If a mechanism such as an MTEF is run as a "parallel" exercise to an actual decision making process and does not enjoy high-level political approval, its effectiveness will be low.*

- *Poor internal oversight mechanisms. Even in cases when a PFM system is effective and an MTEF is meaningfully incorporated into the budget process, internal (governmental) oversight of expenditure program must also be meaningful if programs are to support achieving development. However, expenditure program analysis and evaluation is often rudimentary, and use of cost-benefit analysis, cost-effectiveness analysis, and transparent and objective performance measures to assess programmatic outcomes limited or absent.37 Without effective oversight, the risk of misallocation of resources and poor returns on investment in terms of developmental outcomes is increased.*

- *Poor external oversight mechanisms. MTEFs should be published so that the public can understand a government's expenditure priorities. Governments should report transparently and objectively to the public on the results of expenditure programs. More accountability on the expenditure side of the budget will yield governance dividends as well as improved allocation of budgetary resources.*

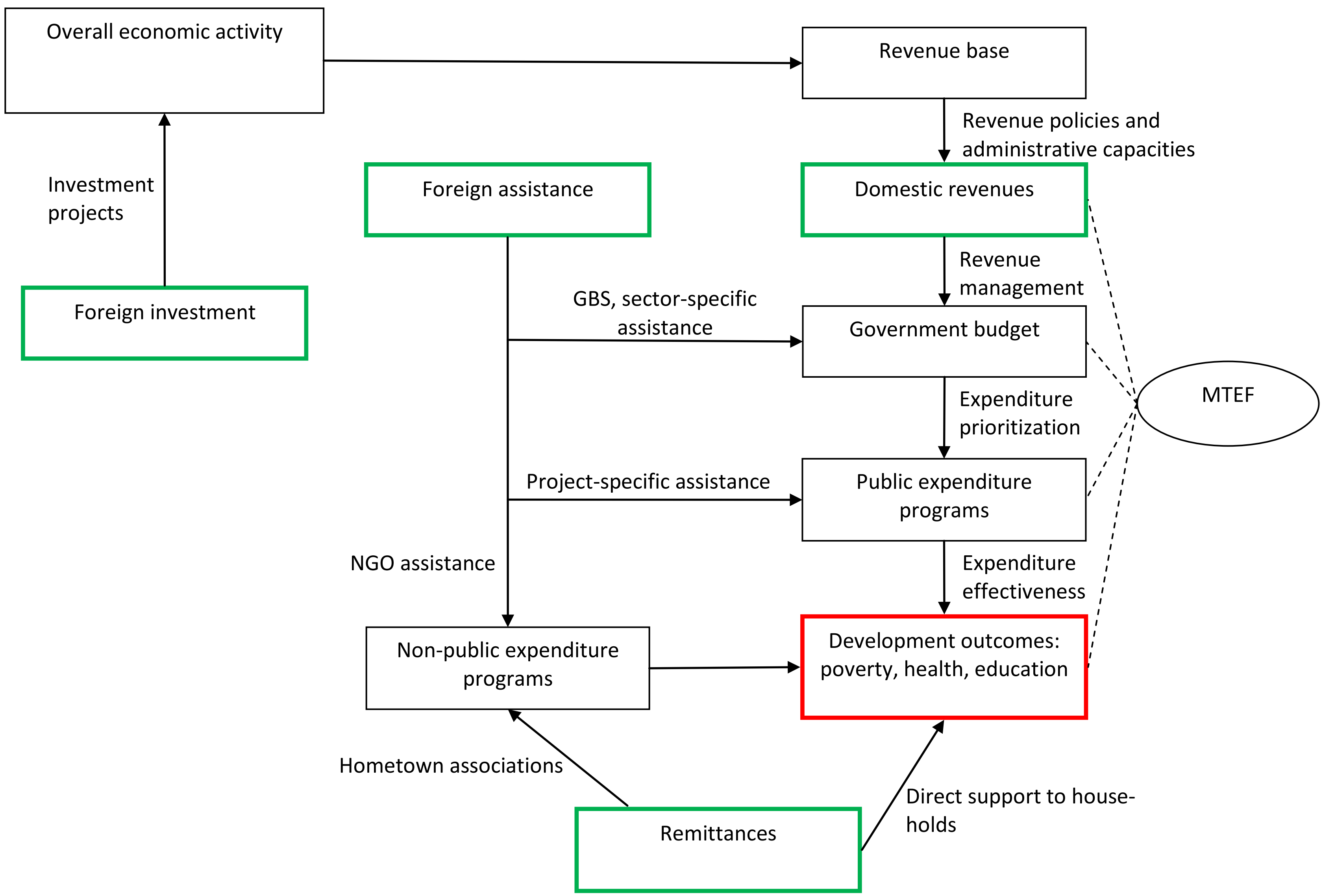
- *External pressure and expenditure prioritization. In two areas that are key for achieving development goals in sub-Saharan Africa, agriculture and health, external pressure to increase prioritization of these expenditures has been exerted. In 2003, African leaders pledged to increase spending on agricultural programs to 10% of the national budget as part of the Comprehensive Africa Agriculture Development Programme (CAADP). In 2001, leaders of countries in the African Union pledged to spend at least 15% of the national budget on programs to improve health. Although these initiatives have arguably played a very useful role in motivating governments to actually achieve these targets, the need for external pressure to increase spending on these areas raises the issue of the degree to which these prioritizations are owned by national governments.*

[37] The role of performance indicators and impact evaluation in the design and delivery of foreign assistance is discussed in detail in Koeberle et al (2006), particularly chapters 5, 9, 10, 12, and 14.

4.1. Tax Policies and the Millennium Development Goals

DRM reform primarily promotes achieving the MDGs through increased revenue collection that can be used to finance public expenditure programs. These programs can be implemented through provision of needed goods or services by state-managed agencies or contracted private providers, or programs that subsidize the price of a good or service sold by private producers.[38] However, in some cases, tax policies *per se* could conceivably be used to alter incentives or re-distribute income to support achieving the MDGs. Areas that seem particularly relevant in this regard include poverty reduction targets (target 1.A), employment targets (target 1.B), and environmental targets (targets 7.A and 7.B). A review of the issues involved in using tax policies *per se* to achieve these targets is beyond the scope of this paper.

[38] It is important to note that in addition to direct provision or subsidization, expenditure programs could in some cases also be implemented as tax expenditure programs, which do not explicitly appear in the government budget and are financed through foregone tax revenues (see section I for more discussion.) It is not clear what MDGs would be best promoted through state provision of goods or services, subsidy schemes, or tax expenditure policies.


Overall economic activity
Revenue base
Revenue policies and administrative capacities
Investment projects
Foreign assistance
Domestic revenues
Foreign investment
Revenue management
GBS, sector-specific assistance
Government budget
MTEF
Expenditure prioritization
Project-specific assistance
Public expenditure programs
NGO assistance
Expenditure effectiveness
Non-public expenditure programs
Development outcomes: poverty, health, education
Hometown associations
Direct support to house-holds
Remittances

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6. APPENDIX

6.1. Appendix A: Six Sub-Saharan Case Studies of Domestic Revenue Mobilisation Reforms Related Programmatic Support

Deeper insights into the effectiveness, impact, and sustainability of aid in increasing domestic revenues can be gained by examining case studies of specific country experiences. This section reviews the experiences of six sub-Saharan African countries: Ghana, Liberia, Mali, Mozambique, Tanzania, and Uganda.[39] Each case study provides a high-level overview of economic and revenue challenges facing the country in recent years, and a review of the management and impacts of foreign aid provided to the country for general purposes and to support revenue mobilization reform. Key lessons from country experiences are summarized for the following important areas of aid quality: alignment to national taxation and development strategies; country ownership of reform processes; predictability and flexibility of aid flows; revenue mobilization reform and governance; aid conditionality; and the role of non-DAC providers.

6.1.1. Ghana

Indicators of Tax Revenue and Ongoing Reform Priorities

Strengthening revenue mobilization remains an important priority in Ghana. As of 2010 tax revenue continued to rise steadily as a share of non-oil GDP to reach 13.2 %. It is projected to increase to 17.5 % by 2012. Ongoing reforms include the targeting of large taxpayers and customs administration reform.

GHANA Central Government Tax Revenue as a % of non-oil GDP 1/

		2009	2010	2011 (est.)	2012 (proj)
Non Oil Tax Revenue		12.3	13.2	16.7	17.5
o.w.	Direct tax	4.7	5.3	7.0	7.7
	Indirect tax	5.5	5.4	6.7	6.7
	Trade tax	2.1	2.5	3.0	3.0

Source: IMF Country Report No.12/36 (February 2012)

[39] The case study material for Ghana, Liberia, Mali, Mozambique, and Tanzania is taken verbatim or with minor modifications from appendix 4 of Nathan Associates (2011). Contacts who provided information and insights for the case studies in this report included officials of the country's revenue authority, officials from international organizations and development agencies, and consultants (see annex 1 of the report.) Material for Uganda and additional material for Ghana and Tanzania is also taken from "Aid as a Catalyst to Increase Domestic Tax Revenue in Sub-Saharan Africa," a report prepared by the Uganda Revenue Authority for the Development Cooperation Forum. Relative to the draft of the study presented at the Luxembourg High-Level Symposium, the case studies were updated with reference to the governments' *Memoranda of Economic and Financial Policies* or other background material contained in the latest IMF Country reports.

Revenue Mobilization Challenges and Reform Accomplishments

In 1986, the Ghanaian Government established the National Revenue Secretariat to sustainably strengthen tax administration. Since then, the Government has pursued several institutional arrangements to strengthen domestic resource mobilization, and implemented a comprehensive set of tax policy reforms. In 2009, the Government established the Ghana Revenue Authority (GRA) as an apex body that is charged with improving taxpayer services, modernizing tax and customs processes, strengthening taxpayer compliance, widening the tax base, and generally making tax administration more fair, transparent, accountable, and accessible. The entire tax environment is expected to change, with automation as a central – and costly – element for bringing the revenue departments into the 21st century. At the same time, the Government has established a transparent and rule-based framework for management of oil and gas revenues.

Reform contributed to an initial dramatic increase in the tax-to-GDP ratio, from 5.6% in 1983 to 17.0% in 1994. The ratio continued to increase in the 2000s, reaching almost 25% by 2007. The work on the establishment of a large taxpayer unit (LTU) was initiated in 2004, to collect revenues from the 350 largest taxpayers in the country. The LTU is now fully operational and is expected to raise almost 70% of all tax revenues, illustrating how important collections from large taxpayers often are in developing countries. Companies are assigned to the LTO on the basis of industry-specific criteria (e.g., for mining and financial services) and turnover. Medium and small taxpayers are also being identified, with the aim of launching a registration process in 2012. In 2011 the ratio of tax revenue to non-oil GDP is estimated to reach 16.7% of GDP and set to increase further in 2012. Partly as a result of oil production, and the accompanying increase in economic growth to a projected 13.5% in 2011, fiscal indicators have greatly improved, providing scope for infrastructure investment. Strengthening domestic revenue mobilization continues to be a key priority however.

The revenue authority has faced important challenges with respect to personnel issues. Recruiting and retaining qualified personnel has been difficult, compounding shortages of supervisory staff. Senior appointments, included the Commissioner and Deputy Commissioner, are now in place. Business processes are being fully computerized, with extensive introduction of information technology (heavily supported by donor aid). VAT and direct tax are being integrated under a single office, with ongoing training of staff, and VAT exemptions are being rationalized (including those granted by the Ghana Investment Promotion Center). Customs administration is being strengthened by supporting legislation and improvements in the system for the valuation of imported goods at the border. A number of measures relating to the taxation of natural resources are planned for the 2012 budget. These are expected to have a beneficial impact on domestic revenue mobilization.

Organization and Impact of Foreign Assistance to Domestic Revenue Mobilization

Foreign donors have supported DRM reforms in Ghana at many stages through technical cooperation, including introduction of Automated System for Customs Data (ASYCUDA) for customs collection and introduction of VAT. Since 2002, a multi-donor budget support (MDBS) program has provided funding to supplement domestic revenues. The MDBS program is derived from Ghana's national strategy for poverty reduction and economic growth. Funding is based on a holistic annual review of performance in achieving the goals of this strategy. Domestic revenue mobilization is supported indirectly in the base tranche through the principle of maintaining sound economic policies; there is also a performance tranche, but without revenue triggers.[40] The MDBS program has a Progress Assessment Framework (PAF) with several structural indicators for Revenue and Transparency. For 2010 they were commencement of integration of departments in the GRA, and selection of criteria for allocating taxpayers to the large, medium, and small taxpayer offices, respectively. These benchmarks were met. The 2011 indicator calls for completion of the Taxpayer Identification Number and registration modules for the new tax IT system. Indicators for 2012 remain to be determined.

Under the MDBS, revenue mobilization is spearheaded by the Ministry of Finance and Economic Planning, under the Public Financial Management (Revenue and Expenditure) Steering Group, and through the Information Management Working Group (automation). The Government is concerned to limit the number of committees to essentials. The governance structure for revenue mobilization is supported through a GRA Reform and Implementation Committee, chaired by the Commissioner General. Given the importance of revenue mobilization and the need for support to the GRA, this committee could form the nucleus for a donor revenue committee or establishment of a revenue basket.

Currently, direct support for domestic revenue mobilization is provided by the IMF, GIZ, and SECO; with additional support from the World Bank for automation through the eGhana project. GIZ is the main bilateral agency in this area, through the Good Financial Governance (GFG) Program, in cooperation with SECO. Tax administration and tax policy is one focus of GFG, along with budgeting and budget implementation, accountability to Parliament and society, and transparent revenues from extractive industries.

In addition to the GRA reforms and the transparency initiatives, a major link between the revenue system and governance is support for local authorities. Local governments are traditionally funded by the Central Government through a Common Fund set-aside. But their capacity is still very limited. A Program for Decentralizing Reforms is designed to build capacity in the regional governments, with significant German support from both DED (now merged with GTZ into GIZ) and KfW. In addition, a large World Bank operation is scheduled for approval. One way in which the central government is actively seeking to increase local capacity is through a program of having GRA officers work with and train local government revenue officers. In particular, this is being tried with property tax, which is a local government responsibility.

Key Lessons From the Experience in Ghana

Harmonization and coordination of donors

- The multi-donor budget support (MDBS) program is the Government's preferred modality in the delivery of aid. It allows the Government to determine the allocation of funds received from development partners (DPs), and increases the Government's ownership of the process.

[40] Base tranches provide funding when a country fulfills eligibility criteria, whereas performance tranches disburse funding according to achieved outcomes. In the Ghanaian case, given the recent budget deficits, the base-tranche criterion of maintaining sound economic policies has evidently been applied loosely.

Alignment to national taxation and development strategies

- The MDBS program provides funding to supplement domestic revenues and is derived from Ghana's national strategy for poverty reduction and economic growth. Funding is based on a holistic annual review of performance. Domestic revenue mobilization is supported indirectly in the base tranche through the principle of maintaining sound economic policies.
- Establishment of a revenue basket may offer advantages by increasing the pool of funds available and ensuring that they are at a level adequate to meet revenue modernization needs. A revenue basket also ensures alignment with government priorities. However, the Government of Ghana appears satisfied with the current donor governance framework and is reluctant to add additional layers unless they deem it essential.
- It is important for the donor community to provide support to improve the management of non-tax as well as tax revenues, especially in light of future oil revenues.

Country ownership of reform processes

- A merger of tax administration under one authority is most effective if the reform is fully owned by both the Government and Parliament, and not imposed by donors. Donor support is welcome, but is should not interfere in the ownership.
- There is a need to anticipate institutional rivalries among the revenue departments and agencies, and to provide adequate and timely resources for recruitment and training of staff. In short, there is a need for skills in change management.

Predictability and flexibility of aid flows

- The MDBS mechanism has increased predictability of donor funding, helped to improve PFM systems, and facilitated policy dialogue between Government and Development Partners, while lowering transactions costs associated with the management of aid on both sides.
- Revenue modernization needs adequate funding to succeed, and considerable donor support to the revenue program will be needed through the medium-term, based on a fully-costed Corporate Plan that the Government is completing.

Revenue mobilization reform and governance

- The roles of the revenue authority and Ministry of Finance must be clearly and formally defined, and component agencies of the revenue agency should be accountable to the authority.
- Good governance requires consultation, education, and training for all stakeholders about changes in policies and systems and their procedures.

Aid conditionality

- Domestic revenue mobilization is supported indirectly in the base tranche of the MDBS through the principle of maintaining sound economic policies. However, given the recent budget deficits, this principle has evidently been applied loosely.

6.1.2. Liberia

Indicators of Tax Revenue and Ongoing Reform Priorities

The current budget in Liberia strikes a balance between priority spending needs and efficient budget execution. As of 2010, tax revenue rose marginally as a share of GDP to reach 22.3 %. It is estimated to have increased to 25.1 % in 2011 on account of strong corporate taxes and a one off transfer related to a concession transfer. Ongoing reforms include the rationalization of investment tax incentives, the strengthening of the large taxpayer directorate, as well as further advances in information technology and audit.

LIBERIA	Central Government Tax Revenue as a share of GDP 1/				
		2009	2010	2011 (est.)	2012 (proj)
Tax Revenue		22.0	22.3	25.1	21.3
o.w.	Direct tax	7.6	7.5	10.4	8.0
	Indirect tax	3.9	4.2	4.5	4.8
	Trade tax	10.2	9.8	9.8	8.1

Source: IMF Country Report No.11/345 (December 2011)

Revenue Mobilization Challenges and Reform Accomplishments

Since 2003, when a peace accord ended 14 years of devastating civil war, Liberia has achieved great progress despite serious difficulties and risks. In 2006, democratic elections brought in a strongly reformist government that moved decisively to start the lengthy process of re-establishing public financial management systems, delivering essential public services, and laying the foundations for local government revenue collection and public service provision. The country still faces monumental challenges in all areas.

Despite extreme capacity constraints and a large share of non-monetized economic activity, revenue performance has been remarkable. In 2011, total revenues (excluding grants) reached 31.2% of estimated GDP. In the initial fiscal recovery, the Government focused on overcoming corruption in customs and gaining quick wins by re-negotiating concessions for forestry, ship flagging, mining (mainly iron ore), and more recently, palm oil. In 2010, concession revenue yielded 11% of GDP. The Government has also sold offshore oil exploration rights to a major company. To ensure transparency, the Government enacted the Liberia Extractive Industries Transparency Initiative (LEITI) Act in 2009 that is consistent with the principles of the Extractive Industries Transparency Initiative (EITI) and covers forestry and agriculture as well as extractive industries. The EITI Board commended Liberia as the “Best EITI Implementing Country” in 2009.[41]

[41] The EITI is a multinational initiative that promotes transparency in payments related to extractive industries through a statement of principles, six criteria, reporting guidelines, administration of a trust fund, an annual conference, and promoting dialogue of key stakeholders, including national governments, international organizations, corporations, and NGOs. As of mid-2011, EITI was being implemented in 35 resource-rich countries.

The second quick win was on customs revenue, and trade taxes amounted to 9.8% of GDP in 2010. This performance was driven by an early decision to enforce a pre-shipment inspection regime, streamline systems for paying import duties, and improve port management. The income tax has also performed well, supported, among other things, by a tax awareness campaign, a whistle-blower law to reward those who report false tax declarations, and introduction of an automated payment module. Nonetheless, tax administration is hindered by poorly trained and paid staff, and lack of reliable data, especially from the large informal sector.

The Government accords a high priority to strengthening revenue collection and modernizing revenue administration. Far-reaching changes in tax policy and tax administration are underway, as well as improvements in public financial management. Other key reforms include the establishment of a revenue authority; the introduction of VAT (in compliance with the Economic Community of West African States, ECOWAS, standards); a comprehensive human resource management (HRM) program; and implementation of LEITI to ensure full disclosure of revenues from mining, petroleum, and forestry. A number of amendments to the Liberian Revenue Code were enacted in 2011 to centralize revenue legislation. The Code also provides standard terms for mining taxation. It will contribute to strengthened taxpayer protection and the reduction of administrative discretion in granting tax incentives.

Organization and Impact of Foreign Assistance to Domestic Revenue Mobilization

Liberia remains extremely dependent on aid. Since the end of hostilities, official grants have exceeded GDP each year, though this figure is steadily declining. The Government manages aid through the Liberia Reconstruction and Development Committee, which provides a platform of Working Committees for coordinating, monitoring, and evaluating projects and programs and reporting on progress. Liberia also receives significant funding from private foundations. Donor coordination overall is well-structured and harmonious.

Revenue reforms have been driven by the Government itself, with only moderate donor support in the past. For example, the principal multi-donor agreement on a Government and Economic Management Assistance Program (GEMAP), which was run by USAID starting in 2005, was not heavily involved with tax issues, aside from some assistance with customs reforms and training of revenue (and expenditure) staff. The IMF also has been providing technical assistance since 2006, including a resident tax advisor posted in May 2010. Support for revenue mobilization has been growing, though, including assistance from the African Development Bank (AfDB), ECOWAS, the EU, the French Government, the US Treasury Department, and the World Bank and the IFC.

One critical activity is the introduction of an Integrated Tax Administration Services (ITAS) system to cover all aspects of tax administration. The system is estimated to cost $11 million, including $2 million under a World Bank project. The project was launched in August 2010 and encountered some early problems such as the absence of a prior mapping of business processes, difficulties in staff retention, and a need to scale back the modules to fit the funding. The current focus is on taxpayer identification numbers. Liberia's experience with introducing IT systems for tax administration underscores the need for careful planning and costing, with support from the international community. Human resources are another challenging area, as there has been a considerable loss of tax personnel to the private sector after they get training. Salaries are thus an important issue for state-building, and under post-conflict conditions, donor-funded top-ups can be warranted as an interim measure. Government officials also stress the need for advisors to remain on the ground through the medium-term to work alongside and mentor local staff, as well as provide training.

Looking forward, Liberia's revenue modernization will need extensive financial and non-financial support over the next decade. The Government has developed a strategic plan for revenue and customs, and will be seeking donor support in the range of $35-40 million. There is no doubt that Liberia's revenue modernization will need extensive financial and non-financial support, and that donor coordination on the ground is imperative.

Key Lessons From the Experience in Liberia

Harmonization and coordination of donors

- The Government manages overall aid through the Liberia Reconstruction and Development Committee, and donor coordination overall has been well-structured and harmonious. However, revenue reforms have been driven by the Government itself, with only moderate donor support in the past. An increasing level of donor involvement in this area may require attention to donor coordination in this area.

Alignment to national taxation and development strategies

- Liberia has a Poverty Reduction Strategy in place (the PRS will be succeeded by an Economic Growth Strategy in 2012), and a PFM reform strategy was recently submitted to the government for approval. The need for coordination of DRM reforms with national taxation and development strategies is likely to intensify in the future.

Country ownership of reform processes

- Even in a post-conflict setting with near total collapse of governance systems, strong and dynamic leadership from a reformist President, Minister of Finance, and Deputy Minister for Revenue can produce rapid improvements in revenue mobilization.
- Liberia's experience confirms the relative ease of collecting import taxes in a post-conflict setting, if political will is present.
- Liberia's commitment to successful negotiation of natural resource concessions has been a major factor in the rapid increase in revenues. These concessions were able to more rapidly begin production and generate tax revenue. Also notable is Liberia's early entry into the EITI to ensure full disclosure of revenues from mining, petroleum, and forestry.
- The Government's decision to establish a Whistle-blowing Act as an integral part of the revenue program can have dividends in other sectors, and be a model for other developing countries.

Predictability and flexibility of aid flows

- Liberia's revenue modernization will need extensive financial and non-financial support over the next decade, and predictable and flexible aid flows will be needed to achieve success.

Revenue mobilization reform and governance

- Some Liberian initiatives related to revenue mobilization have also yielded governance dividends (including commitment to successful negotiation of natural resource concessions, early entry into the EITI, and the establishment of a Whistle-blowing Act as an integral part of the revenue program).

Non-DAC providers

- Liberia receives significant funding from private foundations and other non-governmental sources. Challenges are faced with achieving proper tracking, monitoring, and coordination of this funding by the public sector.

6.1.3. Mali

Indicators of Tax Revenue and Ongoing Reform Priorities

As of 2010, tax revenue in Mali remained close to the level registered in the previous two years, at 14.6 % of GDP. It is estimated to decline slightly to 14.3 % in 2011 due to strong corporate taxation which partly offset a decline in oil taxation associated with the policy of limiting the pass-through of imported oil prices. Ongoing reforms include the rationalization the tax system and streamlining exemptions.

MALI Central Government Tax Revenue as a share of GDP 1/

		2009	2010	2011 (est.)	2012 (proj)
Tax Revenue		14.7	14.6	14.3	15.1
o.w.	Direct tax	4.2	4.4	4.2	4.1
	Indirect tax	8.0	7.7	7.9	8.9
	Trade tax	2.6	2.5	2.3	2.2

Source: IMF Country Report No.12/3 (January 2012)

Revenue Mobilization Challenges and Reform Accomplishments

Over the past decade, growth in per capita GDP in constant 2005 international (PPP) dollars averaged over 2 percent per year, lifting per capita income from $760 in 2000 to $955 in 2010. But Mali is still one of the poorest nations in the world, and it remains heavily dependent on foreign aid. In 2009, foreign grants and net loans totaled 9.3% of GDP, and external financing covered 60% of the capital budget.[42]

[42] IMF Country Report No. 11/141.

The Government pursued major tax reforms since the Directorate General for Taxes (DGI) was established in 2002 with a mandate to modernize tax administration, improve taxpayer services, broaden the tax base, and strengthen revenue mobilization. Revenue performance remained fairly weak. In 2009, for instance, tax collections amounted to 14.7% of GDP – below the tax ratio in 2005 . Among the factor contributing to this were the relative decline in customs revenue due to trade liberalization, extensive exemptions for many large companies; tax evasion by elites; lack of political backing for strengthening the urban property tax; corrupt practices in the revenue service; and a general lack of tax compliance. Several reforms were pursued in 2011, including to enhance the operation of the VAT which currently accounts for 40% of tax revenue. The draft budget laws for 2012-14 include a number of important tax measures, including increased transparency on existing exemptions (e.g., in the General Tax and customs Code, the Investment Code and the Mining Code with a view to estimate tax revenue foregone and gradually phase them out.

Organization and Impact of Foreign Assistance to Domestic Revenue Mobilization

The issues of harmonization and alignment are highly salient in Mali, given the large number of Technical and Financial Partners (TFPs) involved. The Government and the TFPs have established a Joint Assistance Strategy (JAS) with 10 thematic groups, 3 cross-cutting groups, and numerous sub-groups. Participants view the mechanism as working reasonably well. The JAS provides for joint dialogue, joint work plans, joint procedures for review, joint monitoring, and an effective division of labor. Nonetheless, there is still fragmentation as different TFPs respond to their own administrative and political requisites, and often have distinct priorities and approaches.

In 2010, nine TFPs funded general budget support (GBS), totaling about 2% of GDP. The World Bank is the largest contributor. The GBS performance matrix had 39 “triggers” with 60 indicators, including a target for the tax ratio (which was not achieved.) Support for the tax system is coordinated through the Public Finance Management (PFM) subgroup, based on the Government’s PFM program, PAGAM II, covering 2011-2015. PAGAM II has four strategic objectives: efficient and effective revenue mobilization; budget preparation and execution; transparency and responsiveness; and fiscal de-concentration and decentralization. The revenue objective has four intermediate objectives – predictability; revenue mobilization; appropriate issuance of domestic debt; and harmonization between local and state revenue systems – with a total of 20 indicators. Support for PAGAM II is channeled through bilateral projects and programs. It is not a common fund.

From 1997 to 2005 a CIDA program called PAMORI was the flagship donor program to strengthen and modernize tax administration, supplemented by IMF tax missions. PAMORI achieved substantial success, but since 2005 progress has been slow. Planning for PAMORI II began in 2007, again as a CIDA project, but the implementation has been very slow to materialize. Meanwhile, CIDA has provided intermittent assistance, and the IMF has continued with short-term missions and training, mainly through its technical assistance center for West Africa (AFRITAC-West Africa). The French Ministry of Foreign Affairs (MAE) has also been providing training, advise, and technical support through one *cooperant* in the DGI and one in the customs directorate (DGD).

The PAMORI project, until 2005, yielded some important improvements in governance. A central achievement was to establish a strategic planning process, professionalize tax administration, and streamline business processes. These reforms benefited every citizen who is in contact with the tax system, though problems have not gone away. One informed source indicated that the program at DGI has motivated reforms in other ministries, particularly in strategic planning, results-based management, and remuneration reforms. PAMORI also helped the Government to strengthen public information about the tax system, and facilitated consultations with the business community. Finally, in tandem with reforms to improve the revenue system, the Government and its international partners have also been working to improve budget management and strengthen public finance systems at the community level to finance local economic development.

Key Lessons From the Experience in Mali

Harmonization and coordination of donors

- The JAS process has been highly effective in coordinating aid programs at all levels and establishing a workable division of labor. There is still significant fragmentation below the JAS surface
- Monthly meetings of the PFM subgroup are a helpful mechanism for regular review of budget and revenue issues and coordination of donor activities.
- The GBS program is very attractive in terms of the Paris principles, and as a framework for high-level policy dialogue. But it has not created effective incentives for domestic resource mobilization. Performance reviews have been characterized by a high degree of forbearance on "triggers," and the broad set of indicators dilutes the incentive value of each one.

Alignment to national taxation and development strategies

- The PAGAM II sector program is an excellent framework for coordinating donor and government activities, and embedding revenue reforms in a broader PFM framework. But the sector program does not involve a common fund or SBS arrangement. Donor activities are mainly bilateral arrangements, without harmonized systems and procedures.
- Another strength of PAGAM II is its focus on integrating local and national finance systems within the sector program, to strengthen fiscal decentralization.

Predictability and flexibility of aid flows

- From 1997 to 2005, aid flows under the PAMORI program were predictable and significant and achieved substantial success in establishing a strategic planning process, streamlining business processes, and professionalizing tax administration. Since 2005, progress has been slow, and assistance has been intermittent. Planning for PAMORI II began in 2007, but implementation has been very slow to materialize. The sluggish progress since 2005 shows the value of having a predictable funding mechanism such as a tax basket rather than relying on bilateral support.

- The IMF has provided short-term missions and training, mainly through its technical assistance center for West Africa (AFRITAC-West Africa). However, Afritac-West does not have the capacity for comprehensive involvement.

Revenue mobilization reform and governance

- The PAMORI project yielded some important improvements in governance, including establishing a strategic planning process, professionalizing tax administration, streamlining business processes at the DGI, strengthening public information about the tax system, facilitating consultations with the business community, and improving budget management and strengthening public finance systems at the community level. These reforms benefited every citizen who is in contact with the tax system, and they may have motivated reforms in other ministries, particularly in strategic planning, results-based management, and remuneration reforms.

6.1.4. Mozambique

Indicators of Tax Revenue and Ongoing Reform Priorities

Tax revenues in Mozambique have increased steadily over the past few years to reach 15.6% of GDP in 2010 and an estimated 18.1% in 2011. The focus of ongoing tax administration reforms is on business-friendly policies to support the contribution of the private sector to economic growth. A number of additional measures are planned for 2012, including the introduction of a new single taxpayer and identification number and further efficiency gains in tax administration.

MOZAMBIQUE	Central Government Tax Revenue as a share of GDP 1/				
		2009	2010	2011 (est.)	2012 (proj)
Tax Revenue		15.6	18.1	18.8	19.5
o.w.	Direct tax	5.2	5.9	6.1	6.5
	Indirect tax	8.6	10.1	10.4	10.8
	Trade tax	1.5	1.7	1.8	1.9

Source: IMF Country Report No.11/350 (December 2011)

Revenue Mobilization Challenges and Reform Accomplishments

Since 1998 the Government of Mozambique has been pursuing a well sequenced program of fundamental reforms to the tax system, including the establishment of the Mozambique Revenue Authority (MRA) in 2006 and the introduction of a highly simplified tax regime for micro and small enterprises in 2009. On the policy side, the current tax code largely conforms to international good practice for a developing country, with primary reliance on broad-based consumption and income taxes. The MRA has been highly successful in widening the tax base and achieving ambitious targets for revenue mobilization, as the revenue ratio has increased from 14.1% of GDP in 2005 to an estimated 18.8% in 2011. This was achieved despite reduced import duty rates and the effects of preferential trade arrangements on revenue from trade taxes.

Mozambique's revenue ratio is now well above the median for low-income countries in sub-Saharan Africa and low-income countries globally. Looking ahead, Mozambique faces the challenge of adequately taxing the booming natural resource sector, striking a balance between mobilizing domestic revenue while preserving the attractiveness of the sector for FDI.

Organization and Impact of Foreign Assistance to Domestic Revenue Mobilization

Mozambique has been one of the most aid-dependent countries in the world. In 2009, net aid flows amounted to 14.5% of GDP, and two-thirds of the government's capital budget was externally financed. Support for the tax system, in particular, has evolved on four levels. The most prominent modality is a multi-donor common fund (CF), or "tax basket" providing approximately $6 million per year in direct support for the MRA. Second, revenue issues are also addressed in a common fund at the Ministry of Finance level for implementation of an integrated electronic public finance management system (SISTAFE). Third, the 19-agency general budget support (GBS) program includes one revenue indicator in the performance matrix, targeting a steady rise in the ratio of government revenue to GDP; revenue performance is assessed in more detail through the PFM coordination group (as well as the tax basket group). Fourth, several bilateral and multi-agency agencies have provided assistance to the government in modernizing and strengthening the revenue system. In 2012, Mozambique is expected to benefit from technical assistance provided through the new IMF Topical Trust Fund for Managing Natural Resource Wealth (TTF-MNRW).

Mozambique's tax basket, which now has 5 members, is widely regarded as a model for multi-donor coordination in supporting tax systems. The basket has a single joint program, and a single process for dialogue, monitoring, and quality control. It also has achieved a high degree of alignment with host-country systems and priorities, and capacity development for the MRA. Furthermore, the MRA has exercised leadership in the CF dialogue, and ownership of the reform agenda. The coordination process, however, has been difficult and time consuming for the lead agencies, and there is still fragmentation in donor requirements, including problems with the timing of disbursements. In addition, the basket agreement has some restrictions on the use of funds.

The foremost governance benefit from tax reforms in Mozambique has been in strengthening the tax system itself and boosting domestic resource mobilization to finance public expenditures. Major achievements have included sustained efforts to improve the efficiency and effectiveness of tax administration, new legislation clarifying taxpayer rights and responsibilities, and steady progress in professionalizing the tax and customs personnel, upgrading internal IT systems, widening the tax base, improving taxpayer services, simplifying procedures, and providing better public information on the tax system. Another governance development is that the MRA will be undertaking the first survey of taxpayers' attitudes in 2011.

The Government has also been pursuing related governance reforms including concerted efforts to modernize public finance management; establishment of tax and customs courts; revenue transparency through the EITI process; and improvements in public-private dialogue on tax issues. Donors and multilateral agencies play an important role in working with the government in all of these areas.

Key Lessons From the Experience in Mozambique

Harmonization and coordination of donors

- The tax basket is a major improvement over fragmented bilateral projects; but it can be difficult to manage, and has some inherent and context-specific limitations as mentioned above.
- There is a need for careful attention to details in the Memorandum of Understanding for the tax basket, on procurement, audit, use of funds, and an ex ante framework for dealing with unexpected problems.
- With the SISTAFE common fund including tax elements, coordination with the tax basket is essential to avoid multiple processes, multiple budgets, and multiple technical approaches. In practice, this coordination is very good.
- Even with active and effective multi-donor programs in place providing budget funding at several levels, there is still a place for technical cooperation to address implementation and capacity development needs. Government-to-government peer support is especially welcome.
- It is essential, however, to have systems for coordinating technical cooperation arrangements within a coherent overall program for tax reform, and to simplify and harmonize procedures for Technical Assistance programs as much as possible.

Country ownership of reform processes

- The MRA has exercised leadership in the Common Fund dialogue, and ownership of the reform agenda.
- Strong local leadership and ownership is essential for success of the tax basket. There is also a need for technical support to help shape the reform agenda. In Mozambique, the IMF in particular has played a critical role.

Predictability and flexibility of aid flows

- There have been problems with the timing of disbursements from the Common Fund. In addition, the basket agreement has some restrictions on the use of funds.

Revenue mobilization reform and governance

- There have been important tax-governance linkages in Mozambique, driven by the government, with international partners in supporting roles.

Aid conditionality

- The GBS program has not had much of an impact on domestic revenue mobilization. This is partly because DRM reform has not been a priority for the GBS program, as the tax basket program exists, and the government has done an excellent job of meeting revenue targets and achieving reform. However, donors are also not applying serious sanctions for missed targets.

6.1.5. Tanzania

Indicators of Tax Revenue and Ongoing Reform Priorities

Strengthening the revenue base is an important priority in Tanzania, where tax revenues have remained close to their 15% level of 2009. Tax revenue as a share of GDP is only projected to register a modest increase by 2012. This improvement in tax performance is expected to arise from ongoing tax administration reforms. The government's economic program for the medium term indicates that measures such as rationalizing **VAT exemptions and adjusting excise taxes** are being considered, backed by public expenditure management reforms.

TANZANIA Central Government Tax Revenue as a share of GDP 1/

		2009	2010	2011 (est.)	2012 (proj)
Tax Revenue		15.3	14.6	15.2	15.6
o.w.	Direct tax	4.6	4.4	4.8	4.9
	Indirect tax	7.5	7.4	7.4	7.6
	Trade tax	1.4	1.2	1.3	1.2

Source: IMF Country Report No.12/23 (January 2012)

Revenue Mobilization Challenges and Reform Accomplishments

Starting in 1994, Tanzania embarked on a major program of tax reforms to increase domestic resource mobilization and reduce aid dependency. The key initiative was establishment of the Tanzania Revenue Authority (TRA) in 1995, with the aim of strengthening tax administration: reducing widespread tax evasion; limiting political interference in tax administration; and freeing the agency from civil service constraints. A second major reform was introduction of VAT in 1998; VAT now generates nearly one-third of total tax collections. The reforms contributed to commendable growth in revenue from under 10% of GDP in 1992/93 to a peak of 15% in 2008/09. Notwithstanding these improvements, revenue growth has not matched the rise in expenditure, so Tanzania is still highly dependent on recourse to foreign assistance.

Opportunities to improve domestic revenues echo some of the original objectives of the TRA in 1995. These include strengthening compliance; widening the tax base to include emerging sectors; and addressing the small business tax environment. Pervasive tax exemptions are a particularly important problem. The value of exemptions almost tripled from 2004 to 2007, although they have fallen somewhat since then. It is estimated that exemptions could account for up to 6% of GDP and, if collected, would have provided 40% more resources for education or 72% more resources for health in 2009/10.[43]

[43] Tanzanian tax exemptions are provided on goods and services of a foreign or official nature (eg goods consumed by the military), to charities and other NGOs whose activities have "direct benefits to society", on consumption goods deemed to have "direct benefits to society" (eg certain human and veterinary medicines, fire trucks), and to companies in order to stimulate economic growth (eg companies established under the Export Processing Zones Authority, mining companies, and companies holding incentive certificates under the Tanzanian Investment Act and the Zanzibar Investment Promotion Act.) The most important exemptions quantitatively are companies holding incentive certificates (45% in 2008-2010), recipients of VAT exemptions (24%), and mining companies (8%). (Donor funded projects received 6% of exemptions.) See "Tanzania's Tax Exemptions: Are They Too High and Making Us Too Dependent on Foreign Aid?," Twaweza Policy Brief TZ.12/2010E:

In addition, human resources remain problematic; internal corruption and taxpayer fraud are still serious issues; taxpayer trust is not yet well developed; and tax legislation itself, which is not a TRA function, requires further simplification. Non-tax revenues are another source of potential revenue gains; these revenues have averaged about 1% of GDP, but there are significant leakages through illegal logging, mining, poaching, and fishing. The government is seeking especially to increase revenues from the mining sector, which are not collected by the TRA. In 2009, the government also initiated entry into the Extractive Industries Transparency Initiative (EITI).

Tanzania has also tried to widen the tax base by implementing a Block Management System (BMS) that maps areas of trading concentration based on geographical or administrative units roughly the size of a block. Tax administration is carried out on the basis of these blocks, which are assigned TRA staff who register businesses and assess and collect revenues. This approach seeks to pull street traders into the tax net through administrative measures ("close monitoring and rigorous enforcement" through neighborhood sweeps) rather than incentives for voluntary compliance. The BMS is viewed by some experts as having produced very little revenue and mainly served to diminish trust in government, although others (including the TRA) view the approach as "highly potent for widening the tax base by capturing new taxpayers and evaders."[44]

Organization and Impact of Foreign Assistance to Domestic Revenue Mobilization

For FY2009/2010, overall foreign assistance in the form of grants and concessional loans totaled approximately 9.4% of GDP, or approximately $2.4 billion, and financed 62% of total development expenditures. Budget support amounted to 5.5% of GDP, including 1.5% of GDP allocated through the budget to sector "basket" programs. Project aid amounts to just under 4% of GDP.

The TRA has received extensive foreign assistance since 1999, when the Tax Administration Project (TAP) that was predominantly run by the World Bank became operational. Some 40 agencies have been providing support over the past decade. A Development Partners Group (DPG) now works with the Government and domestic stakeholders through a complex Joint Assistance Strategy (JAS) that was developed in 2006 to increase aid effectiveness. The JAS draws on the country's poverty reduction strategy (MKUKUTA) and provides a framework for joint dialogue at four levels: a high-level Joint Coordinating Group for discussing overarching issues of policy and aid coordination; a Public Expenditure Review (PER) group; three cluster working groups; and numerous sector and thematic groups that work with relevant ministries.

Since 1995, assistance for revenue mobilization has amounted to an estimated $120 million. Funding has targeted business process re-engineering; IT systems; customs border posts; equipment and building renovation; strengthening tax laws and the judiciary; enhancing taxpayer services; capacity building; studies and training; and support to the Policy Unit in the Ministry of Finance and the Auditor General's office. In 2006 the World Bank and DFID initiated a Modernization Project (TMP) funded at $7.6 million and GBP 16.6 million. A Donor Tax Basket

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http://twaweza.org/uploads/files/Tax%20Exemptions.PDF. See also "Domestic Resources Mobilization for Poverty Reduction in East Africa: Tanzania Case Study," p.26.

[44] See Nathan Associates (2011), p.17, and references cited there.

supporting TMP includes the World Bank (as lead), DFID and the Danish International Development Agency (DANIDA), who provide funding to the basket, and the IMF and the Norwegian Agency for Development Cooperation (NORAD), who provide technical assistance in specific requested areas. Donors participate jointly in biannual project implementation missions to assess progress towards development objectives.

While some donors regard the Tax Basket as the most successful sector fund in Tanzania, others consider progress on tax modernization to be slow and are concerned about revenue performance. In fact, in May 2010, the 14-member GBS group reduced their pledges for FY 2010/2011 by over $200 million, citing continuing large government deficits as a primary concern. Also, the TRA missed its revenue target for the first half of FY2010/2011 by 8%.

Key Lessons From the Experience in Tanzania

Harmonization and coordination of donors

- The tax basket has been very successful in harmonizing and aligning multiple donor contributions for the revenue modernization program. However, it is often claimed that there are too many donors working in Tanzania with too many separate ideas, resulting in a very complicated coordination process. Consideration might be given to having a minimum contribution for participation in a tax basket program.

Alignment to national taxation and development strategies

- The Joint Assistance Strategy (JAS) is a key component of a complex mechanism for coordinating aid which has been in place since 2006 and is intended to increase aid effectiveness. The JAS draws on the country's poverty reduction strategy and provides a framework for joint dialogue at a high-level coordinating group, a Public Expenditure Review (PER) group, three cluster working groups, and numerous sector and thematic groups. There is thus a high level of alignment of revenue mobilization reforms to Tanzania's national taxation and development strategies.

Country ownership of reform processes

- Strong government ownership and leadership, including high-level political support, is critical for successful outcomes. Ownership and support for DRM reform in Tanzania needs to be strengthened and institutionalized. Most importantly, policy shifts, including an explosion in the value of tax exemptions in the late 2000s, have undermined DRM reform and negated the revenue impacts of successes achieved by the revenue modernization program. There is as yet no apparent high-level political will to change this policy stance.

Predictability and flexibility of aid flows

- Better coordination of project aid is needed to ensure appropriate and timely funding for government priorities.
- The TRA has a preference for longer term technical assistance to support hands-on coaching and mentoring, rather than short-term TA.

Revenue mobilization reform and governance

- Tanzania's Block Management System for tax collection illustrates the potential for conflict between revenue collection, governance, and administrative efficiency. This is a case where costs are high relative to revenue, and the process is invasive and probably counter-productive. Although some believe that the BMS has been effective (including the TRA,), there are probably better ways to widen the tax net.
- A lack of awareness and knowledge among tax payers is an obstacle to compliance and also to anti-corruption reforms.

Aid conditionality

- The GBS group reduced their pledges to Tanzania in 2010 by over $200 million, citing continuing large government deficits as a primary concern.
- The IMF has used structural performance criteria to bring about DRM reforms, including formulation of a new Income Tax Act, revision of the VAT threshold, revision of the threshold for the presumptive tax, and curtailment of tax exemptions.

Other lessons

- Despite all the support that has been provided to the TRA, problems with the underlying tax policy regime undermine progress with domestic resource mobilization. Tax exemptions remain a serious problem for revenue mobilization.
- Using indicators like the tax-to-GDP ratio can divert staff from longer-term goals to focus on monthly targets. Measures of collection efficiency or revenue effort (ratio of revenues to collection capacity) are better.
- The TRA especially welcomes assistance from regional sister organizations, through regional mechanisms like ATAF. But support from non-African foreign experts is also valuable because decision makers often pay more attention to them.

6.1.6. Uganda[45]

Indicators of Tax Revenue and Ongoing Reform Priorities

Tax revenue in Uganda remained stable at 11.8% between 2009 and 2010 and it is estimated to have increased to 12.4% in 2011 and projected to increase further to 13.1% in 2012. This is driven by ongoing tax reforms including the elimination of tax exemptions and investment incentives, and stronger tax administration, including with the introduction of a modern e-tax system, the establishment of a national identification system and the elaboration of guidelines on transfer pricing.

UGANDA	Central Government Tax Revenue as a share of GDP 1/			
	2009	2010	2011 (est.)	2012 (proj)
Tax Revenue	11.8	11.8	12.4	13.1

[45] The case study for Uganda is based on and cites extensively "Aid as a Catalyst to Increase Domestic Tax Revenue in Sub-Saharan Africa," a report prepared by the Uganda Revenue Authority for the Development Cooperation Forum. Additional material is drawn from Nathan Associates (2001), box 4.3 on p.31.

o.w.	Direct tax	3.6	3.9	4.2	4.7
	Indirect tax	7.0	6.8	7.1	6.9
	Trade tax	1.2	1.0	1.1	1.1

Source: IMF Country Report No.11/308 (October 2011)

Revenue Mobilization Challenges and Reform Accomplishments

Uganda has enjoyed a stable macroeconomic environment with strong real growth and relatively low inflation. The Uganda Revenue Authority (URA) was established in 1991 under the Ministry of Finance, Planning and Economic Development (MoFPED). In the first half of the 1990s, efforts were made to curb corruption and patronage networks through staff removal, appointment of a new head of the URA, and an increase in average staff salary of 250%. Revenue collection rose from 7% of GDP in 1991 to 12.3% in 1996, but ceased rising in the late 1990s, and this led to further reforms in the mid-2000s. In 2006, a Modernization Plan for revenue collections was adopted to achieve targets set out in Uganda's Poverty Action Eradication Plan and emphasized achieving a high level of voluntary compliance of taxpayers. It is expected that the URA will provide the revenue needed to finance Uganda's National Development Plan. Although significant reform efforts were undertaken in the 2000s, the revenue-to-GDP ratio increased only slightly, from roughly 10% in 2000 to 13.1% in 2010.

URA reforms have emphasized and achieved success in IT upgrading, which was anticipated to reduce corruption and collection costs. The eTax system adopted by the URA has increased taxpayer compliance and improved audits. The gradual introduction of Electronic Tax Registers (ETRs) and e-tax receipting and auditing systems, starting with medium and large companies, is also expected to simplify registration, filing and payments. Efforts continue to be directed towards improving taxpayer services and education, and promoting taxpayer awareness through a taxpayer charter outlining obligations and rights. However, significant challenges continue to be faced. There are numerous tax exemptions and investment incentives which work against increasing revenues. There is scope for strengthening the tax policy function in Uganda. The URA also experiences a high rate of staff turnover due to uncompetitive remuneration levels, and the URA has had trouble retaining personnel with specialized skills in areas such as IT and audit.

Organization and Impact of Foreign Assistance to Domestic Revenue Mobilization

The implementation of the 2006 Modernization Plan was supported by several donors (including the Netherlands, the UK, Belgium, and Denmark) under an integrated basket funding framework at a funding level of roughly $15 million. It was also anticipated that the funding framework would progress to a general budget support mechanism.

Key Lessons From the Experience of Uganda

Harmonization and coordination of donors

- The URA clearly prefers the basket modality as it supports a comprehensive and integrated approach, lowers transactions costs, and facilitates ownership.

- The basket funding arrangement has worked well, but the arrangement could be broadened so as to ensure better coordination and communication between the donors and the URA. The governance structure within the URA for implementing and monitoring reforms was weak. Strong ownership by a URA management that is strongly supported by development partners are needed for success with the basket approach.

Alignment to national taxation and development strategies

- The 2006 Modernization Plan for revenue collections was coordinated with Uganda's Poverty Action Eradication Plan, and current revenue planning is synchronized with the financing needs of Uganda's National Development Plan.

Country ownership of reform processes

- Political leadership has supported reforms to the DRM process, and these have led to improvements in revenue collection performance. However, as in the case of Tanzania, leadership has also implemented tax policies that have undermined the impact of these reforms on the level of mobilized revenues, and relatively little progress in the overall level of revenues has been achieved.

Predictability and flexibility of aid flows

- Flexibility in aid flows is needed so that they can continuously address the areas of tax policy reform, domestic research capacities on taxation, capacity building of the URA, and support to civil society organizations.

Revenue mobilization reform and governance

- Corruption continues to be an important issue for DRM, and strong engagement on tax issues by civil society organizations, including business associations and taxpayer associations, is essential to enhance the legitimacy and accountability of the tax system.
- The URA needs to effectively implement its whistle-blowing policy.

6.2. Appendix B: Aid Modality Characteristics and Issues

Much donor assistance in the past has been provided through bilateral projects in which a donor organization manages its assistance and relationships with recipient stakeholders independently from other donors. Over the past two decades, new aid modalities have emerged that seek to increase aid effectiveness through better alignment, harmonization, and mutual accountability in a context of multiple donors and stakeholders. This appendix defines these modalities, describes their basic features, and reviews key issues associated with them as a mechanism for delivering aid, both generally and with respect to DRM support specifically.[46]

General Budget Support: The OECD defines general budget support (GBS) as "a method of financing a partner country's budget through a transfer of resources from an external financing agency to a partner government's national treasury. The funds thus transferred are managed in

[46] This section summarizes and often cites verbatim chapter 4 of Nathan Associates (2011).

accordance with the recipient's budget procedures."[47] The GBS modality seeks to lower transactions costs associated with aid delivery and promote dialogue between donors and recipient on overall budgetary policies and strategies and the functioning of the public financial management system.

GBS programs are intended to conform maximally to the Paris principles for aid effectiveness, including ownership, alignment, harmonization, managing for results, and mutual accountability. However, the degree of conformity with Paris principles in practice varies from case to case for well known reasons. On ownership, for example, the policy assessment framework that defines programmatic goals, indicators, targets, and disbursement triggers is in some countries squarely based on the government's poverty reduction strategy, while in others it is a conglomeration of donor priorities with government concurrence rather than leadership. And while GBS is fully aligned with host country budget processes and priorities (because the funds are merged into the Treasury account), alignment with the budget cycle is frequently weakened by disbursement delays.[48]

With respect to aid for DRM reform specifically, the GBS modality enables a high-level policy review forum that can focus on revenue performance. It facilitates efficient coordination of the involvement of many donors in reviewing DRM reforms. It is well suited to addressing interactions between taxation and governance, and permits many donors to be involved in reviewing DRM reforms at low transactions costs. The GBS framework also highlights revenue performance and deviations between revenue outcomes and targets. Variable tranche mechanisms, which tie aid levels to DRM performance, have been used to a limited extent in GBS frameworks, but they could provide useful incentives to achieve DRM reforms if local ownership is strong and donors adopt a harmonized approach. In actual practice, because GBS reviews involve much more than DRM objectives, the focus on DRM issues can be relatively weak, and donors have often not applied sanctions in instances of DRM performance lapses.

Sector Budget Support: Sector budget support (SBS) is "a transfer to the national treasury in support of a sector program, policy and strategy". It does not differ procedurally from GBS but supports a sector strategy as opposed to a national development strategy.[49] Most of the issues associated with GBS apply to SBS as well, although SBS adds a layer to requirements for aid coordination and management as it applies to a particular sector. DRM aid provided through the SBS modality usually is a component of a public financial management (PFM) sector program. The SBS modality creates stronger incentives for action and accountability for results with respect to DRM than the GBS modality, because it is more tightly focused on the PFM sector, and a more intensive and expansive diagnostic analysis and monitoring of DRM-related outcomes can be undertaken. A PFM reform program usually involves a focus on both revenue and expenditure reform: this modality is thus more likely to achieve revenue results than a modality that only focuses on DRM reform, because there is a better chance that taxpayers will see benefits resulting from their taxes. However, as in the case of GBS, because its scope is broader, the focus on DRM reforms may be diluted. A variable tranche approach to implementing an SBS

[47] See OECD (2006), p.26.
[48] See Nathan Associates (2011), p.22, and references cited there.
[49] See European Commission (2007), p.37.

program is also seen by some as providing useful incentives. An interesting recent proposal for a variable tranche approach in the SBS program context is the "Cash on Delivery" aid approach proposed by the Center for Global Development.[50]

Basket Financing: Although no official definition of this modality has been established, the basket modality (also called a "common fund") entails pooled multi-donor funding that goes not to the national treasury but to a segregated account or sub-account for designated purposes.[51] Basket funding is a multi-donor partnership and conforms strongly to the Paris principle of harmonization. However, it is less aligned to host country systems and priorities as compared to GBS or SBS, as funds are put into a separate account and earmarked for specific uses. This does permit tracking and auditing funds, which mitigates a major donor concern about budget support. Basket financing reduces the fragmentation that characterizes a purely bilateral project approach, but it does involve more fragmentation than GBS or SBS as each basket involves separate agreements and procedures. Basket financing also requires coordination between the basket group and the partner-country agency, between donors in the basket group, and between the basket group and SBS and/or GBS programs. Management of these relationships can also entail significant transactions costs, particularly for the donors. Basket financing to support DRM reform is a relatively new approach. Prominent examples such as the baskets in Uganda and Mozambique (see next section for case studies) suggest that this arrangement achieves a high level of coordination and alignment and minimizes duplication costs. Because a basket approach is usually a partnership with the host government revenue authority, it is more suitable than SBS and GBS in creating a sharp focus on the specific issues of DRM reforms. However, DRM reform baskets need to ensure that reforms are well coordinated with agencies other than the revenue authority to maximize prospects of success. Donors also should ensure that basket programs include elements that promote state building and good governance, which might be neglected under a purely technical approach. An important issue for the basket approach is the number of partners to be included in the basket: in particular, the benefits of bringing multiple small partners into a common fund may be outweighed by additional management costs.

Other Joint Instruments: Other multi-donor instruments provide funding outside the host government budget. This approach is less aligned to country systems but can be useful as it provides flexible instruments for multi-donor cooperation and produces better harmonization and coherence compared to multiple bilateral agreements. These mechanisms also provide a useful way for smaller donors to support DRM reforms. Two major joint-instrument options are *trust funds* and *joint projects or programs.* Trust funds have been used for many years to pool resources from multiple aid agencies to support a common program. One agency (often the World Bank, UNDP, or IMF) receives and administers the funds on behalf of a group of donors.[52] Trust funds have been used to address revenue issues (Afghanistan is a prominent example.) The World Bank currently does not have a multi-donor trust fund for technical support

[50] See Birdsall and Savedoff (2010).

[51] Trust funds are another type of pooled multi-donor funding (see below.)

[52] Trust funds are widely used. The *2010 DAC Report on Multilateral Aid* indicates that in 2008, the World Bank was handling 2,276 trust funds through its own administrative procedures and 1,503 funds for activities implemented by recipient organizations.

on tax issues, but in 2011 the IMF introduced a trust fund specifically targeting tax policy and administration.[53] Under a joint project or program, many aid activities (instead of one common programme) are structured as a standard project but with multiple donors involved in the financing and often in managing and monitoring the activities. This approach is less well aligned with government systems than a tax basket. The multi-donor approach however improves on the alternative of bilateral interventions by harmonizing donor contributions, and it also offers smaller donors a vehicle for participating in programs. However, this arrangement can entail higher transactions cost and greater funding uncertainty than a traditional bilateral project as it requires coordination among the partners.

Bilateral Arrangements: A large share of aid flow to developing countries, including DRM assistance, continues to consist of "stand-alone" bilateral arrangements. In situations where multiple donors pursue parallel bilateral activities in the same technical area, stand-alone arrangements entail a maximum potential for fragmentation, inconsistency, and elevated transactions costs. Nonetheless, bilateral aid has some practical advantages in that it simplifies negotiations on the project or program agenda. It provides donors with control of funds; avoids the fiduciary risk of budget support; establishes maximum attribution for project results; and provides the donor agency with visibility, which has value for maintaining political support at home. Some donors operate under laws, regulations, and systems that favor bilateral interventions. Some countries have had very favorable experiences with bilateral arrangements, which can work well when programs have strong host-country ownership and leadership at both the political and technical levels.[54] In cases where a single bilateral donor is the dominant source of support for the tax system, coordination and harmonization issues are not much of a problem, but it is still essential to align the support with national strategies and plans and coordinate activities in the framework of a PFM sector program. The more challenging situation is when multiple donors choose independently to support DRM reforms in a particular country. In such situations, it is essential for donors at a minimum to exchange information and coordinate their activities. They should also consider pursuing a tax basket or multi-donor project modality.

[53] This fund will provide roughly $30 million over five years to finance IMF tax experts sustained assistance to 15 to 20 developing countries that are not already benefiting from major donor funding for tax programs.

[54] A striking example is that of Rwanda, which chose to work exclusively with DFID on a long-term basis (and including analytical inputs from the IMF.)