Ending aid dependency through tax: emerging research findings

Aid continues to play an important role helping developing countries reduce poverty and inequality, and attaining global and national development goals. Though efforts to increase its quality and effectiveness must be accelerated, it will be vital to maintain aid flows. However, excessive aid dependence (relying on aid for a third or more of government spending) undermines policy autonomy; accountability and responsiveness to national citizens, and delivery of priority services by government. It also interferes with longterm planning and predictability of government spending. Reducing dependence can therefore improve development results if done in a way that ensures equitable and sustainable development.

Building on previous reports[1], ActionAid has commissioned new research into experiences in reducing aid dependency. This paper presents the initial findings of that research. It shows that developing countries have already rapidly reduced their dependence on aid since its peak in 2002. In least developed countries and low income countries, aid has fallen from more than half to just a third of government spending. Increased revenue mobilisation (in most cases through progressive taxation, especially of larger corporations) and sustained economic growth have been key to this success, with the extractives sectors playing a significant role. However, there is scope to increase the long term impact of reduced dependency in terms of governments being in the driving seat of their own development, in terms of increased accountability to citizens and in terms of using revenues to tackle poverty reduction. And much more could be done to reduce dependency further, notably by ending corporate tax incentives, combating avoidance via tax havens, and combating illicit financial flows.

Learning from experience in Ghana, Sierra Leone, Uganda and Bolivia, the following factors are key to ending aid dependency in a way that is sustainable:

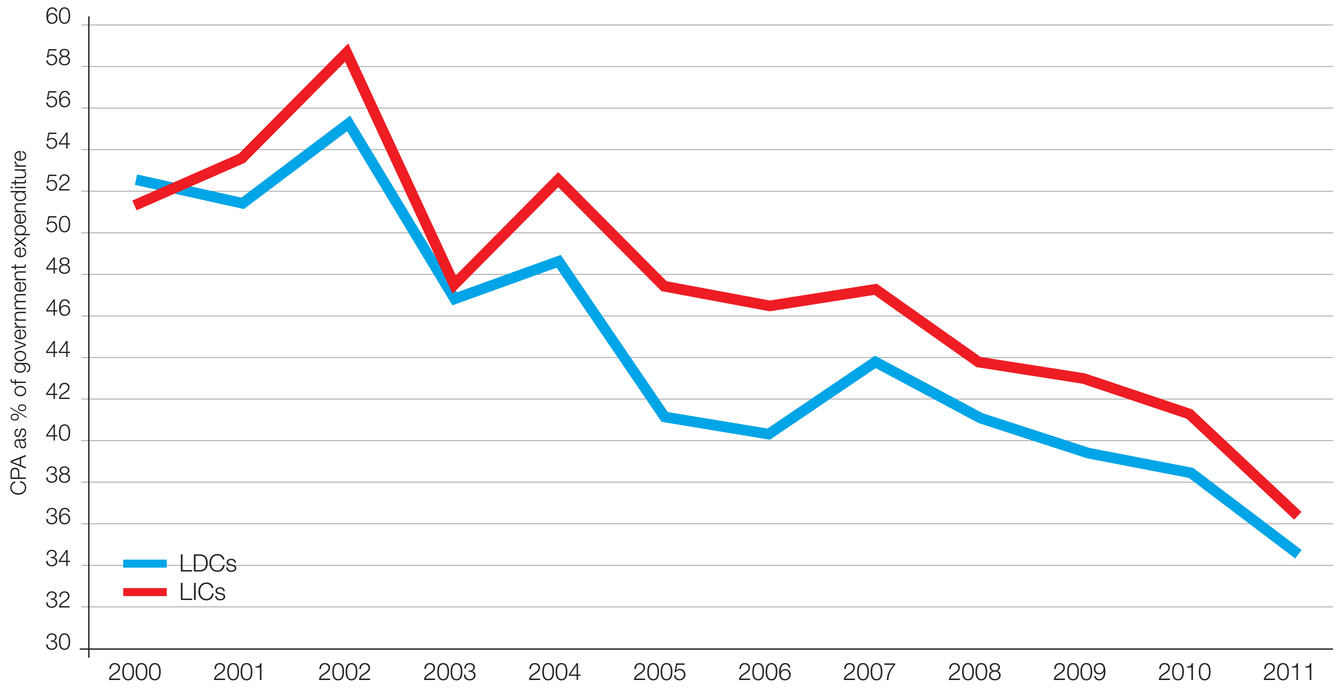
1. **Basing development strategies on increasing progressive taxation**, focussing on large corporates and high-wealth individuals; on combating illicit flows and tax avoidance; and on eliminating harmful tax incentives in laws or treaties, while ensuring tax revenues are used to provide quality public services especially for deprived communities and people struggling with poverty.
2. **Increasing taxation of extractives**, including by renegotiating licenses, contracts and royalty agreements; creating national funds for future investment that will sustain gains over the longterm; and using extractives revenue to promote broad-based growth and diversify the economy.
3. Adopting **aid policies** which include detailed plans to reduce aid dependence and improve the results of aid, and increase government policy autonomy, accountability to citizens and predictability of revenue and spending, while continuing to mobilise aid where needed to support national development goals.
4. Encouraging donors to use aid to support legal, auditing and tax experts to **build government capacity** to negotiate and implement better revenue deals, notably on extractives, tax havens, avoidance and illicit flows.
5. **Minimising more expensive loans or off-budget financing**, in order to keep debt levels sustainable and allow countries to continue to cut aid dependence.
6. **Enhancing parliamentary, civil society organisations and media focus** on government revenue mobilisation, spending plans and actual implementation (and equitable spending) in order to increase accountability to citizens and to increase impacts on poverty reduction.
7. Reducing bilateral aid linkages to IMF programmes, in order to provide space for greater policy autonomy for developing countries.

[1] ActionAid, 2011, Real Aid 3: Ending Aid Dependency

Increased revenue mobilisation is the key driver of falling aid dependence

Since its peak in 2002, aid dependence in Low Income Countries (LICs) has fallen by 22% of government spending and in Least Developed Countries (LDCs) by 20%. In both cases, aid financing has fallen from over half to only one third of government spending (Figure 1).

Figure 1 – aid dependency is falling



Source: Aid – Country programmable Aid from OECD DAC database; Government Spending - IMF WEO April 2013

The key explanation of reduced aid dependence is increased revenue mobilisation. Economic growth has been vital in 26 of 27 countries which reduced dependence (see figure 2). Since 2008, LICs have seen higher per capita growth than emerging or advanced economies.

However, increased revenue effort (measured by revenue/GDP) has also played a key role in 70% of the countries. As shown in figure 2, the increased revenue derived from three main sources:

i) extractive sector (oil, gas, minerals) income via royalties or fees in 12 countries.

ii) direct taxation via income and corporate taxes in 11 countries.

iii) indirect taxation through VAT, sales taxes and customs duties in 5 countries.

These findings show that much of the recent revenue increase has been progressive (coming from income tax or larger corporates including extractives). Nevertheless, there is much more work to be done. ActionAid estimates that eliminating corporate tax incentives in developing countries could raise over US$138 billion in revenue annually, while developing countries are estimated to lose between US$120 and US$160 billion a year in revenue owing to money hidden in tax havens[2].

[2] ActionAid, 2013, #Taxpower - ActionAid's campaign explained, ActionAid International

Figure 2 – increased revenue mobilisation reflects growth and revenue effort

Detailed lessons from country case studies

The ActionAid research investigates four countries in more detail to establish:

- what factors have led to reduced aid dependence
- the impact and sustainability of this fall
- lessons to inform future policies to end excessive aid dependence

The following countries have been chosen to represent different drivers of revenue success. As shown in figure 2, all have sharply reduced their aid dependence since 2000:

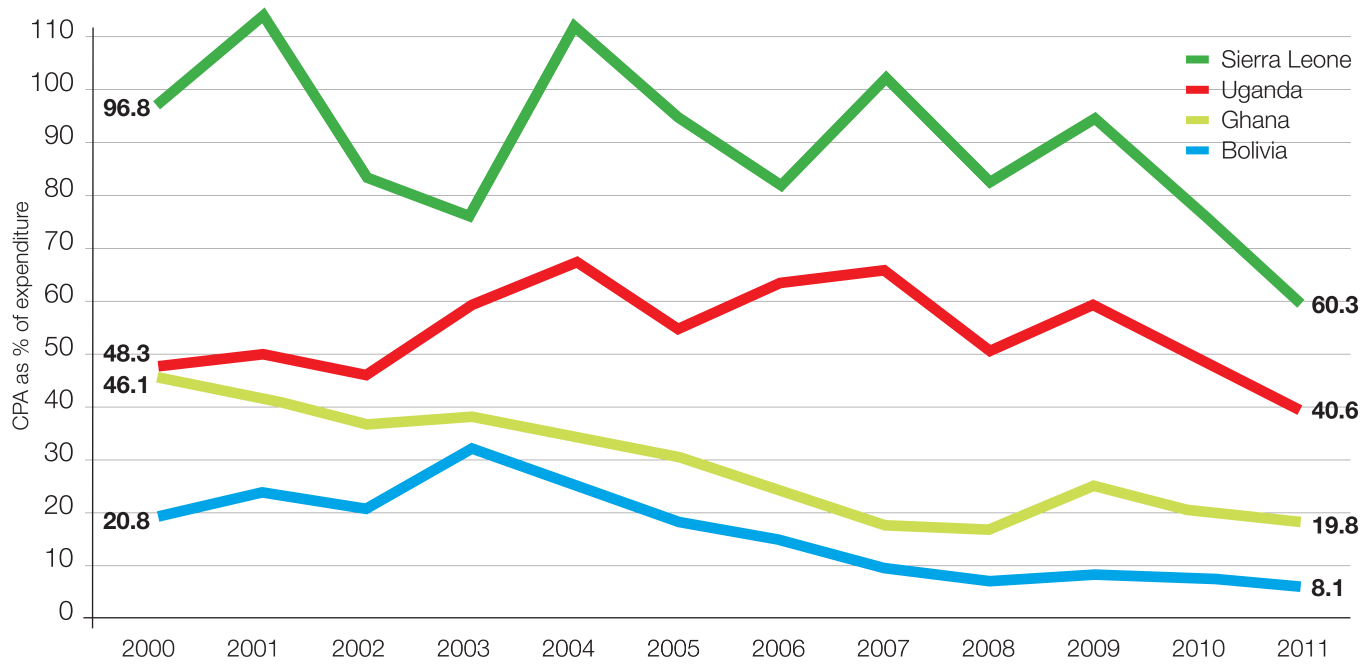
i) Ghana shows long term growth, with increased direct and extractives revenue, but also increased borrowing.

ii) Sierra Leone shows recent growth and higher direct, indirect and extractives revenue.

iii) Uganda shows long term growth, with recent direct tax and extractives revenue increases, as well as borrowing.

iv) Bolivia shows long term growth and increased revenue from the extractives sector.

Figure 3 – Case studies have been chosen for their reduction in aid dependence



Why is revenue mobilisation increasing?

There have been three main reasons for the increased levels of revenue in the four countries analysed:

i) In all four countries, development plans and policies set out clear goals to increase revenue mobilisation and reduce aid dependence. In Ghana, Sierra Leone and Uganda, aid policy documents also showed that aid has been less effective than national resources in aligning behind national priorities, spurring efforts to enhance aid effectiveness or mobilise revenue. However, all plans and policy documents lacked detailed planning or strategies to reduce dependence.

ii) Commitment by state and non-state actors acted as a catalyst. Key political leaders in the executive played a vital role in placing reduction of aid dependence at the top of their agenda. In Sierra Leone and Uganda, parliament also called for reduced dependency and helped to pass laws enhancing tax administration.

In Ghana and Uganda, non-state actors such as the media and CSOs were also vocal, though with less clear impact on the governments.

iii) Ghana, Sierra Leone and Uganda saw examples of well targeted donor assistance increasing growth and revenue mobilisation. Aid helped to foster growth by enhancing human capital through "real aid"[3] which funded education and health spending, and supported country development strategies – enhancing country leadership. It also helped by funding priority infrastructure projects (though governments also had to borrow funds from other sources). African governments also received donor support to establish and increase effectiveness of national revenue authorities, and to enhance negotiating capacity for mobilising extractives revenue. In Bolivia, South-South cooperation and national capacity increased extractives revenue without donor support. Aid also helped to boost the capacity of non-executive actors (parliament, CSOs and the media) to analyse and press for progressive revenue mobilisation and spending policies.

[3] Real aid is effective aid that puts developing countries in the driving seat of their own development.

Impact of the fall in aid dependence

The fall in aid dependence has had three key types of impact:

i) Higher funding of government spending via budget revenues has brought gains in terms of countries' **improved ability to plan and execute spending predictably.** (Aid disbursements had been very unpredictable). This has been particularly true where aid now accounts for less than 10% of spending, such as in Bolivia.

ii) With aid continuing to fund 20-60% of spending, African governments are less responsive to citizens' priorities for service delivery, continuing instead **to be more accountable to donors**, something that is a key problem associated with aid. However, there is evidence of greater responsiveness to citizen pressure, as reflected in campaigns on water and health spending in Sierra Leone, health spending in Ghana, and extractives in Ghana/Uganda. There is even stronger evidence of responsiveness in Bolivia where aid funds only 10% of spending.

iii) All African studies report that there has been **little increase in the ability of governments to develop and test their own policies**, with donors continuing to play a significant role in policy discussions, through links to IMF conditionalities and budget support, as well as to private flows. Though there are some signs of increased willingness to act independently from IMF policy advice, this is the area which has seen only limited change. The Bolivian experience is of a more radical political shift and a much larger revenue increase, leading to a long-term break with IMF programmes.

Bolivia – Opportunities and risks in extractive sector revenue

Before 2005, oil and gas companies in Bolivia paid only 18% of profits as royalties to government. However, there was growing popular demand to capture a greater share of the earnings of the extractive sector. A new government was committed to increased earnings from the nation's resources and to higher spending on national development. It consequently established a hydrocarbons tax at 32% of the value of oil produced.

In spite of initial threats by producers, there has been no decline in production of extractives. Large revenue increases have resulted, with extractive revenue rising from 14% to 33% of total, and by 600% in local currency terms, allowing government to fund 8% of expenditure using aid. In addition, this has funded a doubling of social spending, with a particularly sharp rise in social protection programmes for the poorest citizens, which has helped cut poverty from 63% to 49%. The Bolivia case therefore has positive lessons for LICs in terms of renegotiating contracts with extractives companies.

On the other hand, the government has become more reliant on extractives revenue, raising potential risks. Foremost among these are that proven reserves of natural gas are falling, raising the possibility that revenues could decline sharply over the medium term; that the Government is seeking to increase exploration into indigenous areas and national parks, potentially undermining environmental and cultural sustainability; and that Argentina and Brazil (Bolivia's main export markets for gas) are looking to renegotiate their contract with lower prices. As a result, there is a strong need for Bolivia to invest extractive revenues in enhancing non-hydrocarbons production and infrastructure as well as social spending, to diversify the economy and enhance longterm economic sustainability.

Opportunities and risks to future sustainability

In spite of existing success so far, there remain major opportunities to increase revenue, as well as risks to the sustainability of current policies:

i) Extractives revenues. In all three African countries there is major scope to increase revenue from burgeoning extractive sectors. All have established institutions and legislation which could increase revenues sharply by enforcing tax, royalty and licensing regimes. However, there are also major risks of making the economy and revenue too dependent on extractives – as Sierra Leone found when iron production and prices fell in 2012, leading to revenues 88% below forecasts. Bolivia also highlights opportunities and risks of extractives (see box).

ii) Increasing debt burdens. In Ghana and Uganda, expensive borrowing is becoming an increasing source of finance for government expenditure, in addition to off-budget "public-private partnership" financing for infrastructure. Resulting rising debt burdens could divert revenue away from funding spending.

iii) Lack of focus on inequality and other post 2015 goals. All studies (except Bolivia) highlight that there has been little move by Governments to increase funding to "post-2015" areas such as inequality, social protection, climate change and the environment. The opposite has been true in some cases. In Uganda, expenditure on education and agriculture has fallen since 2010. In this context, both increased revenue and continuing aid flows will be vital to attain the post-2015 goals (as well as those Millennium Development Goals not reached by 2015).

The full research findings will be published by ActionAid in 2013. The research was commissioned by Action Aid from Development Finance International.

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